A QUARTERLY PUBLICATION OF THE INTERNATIONAL MONETARY FUND AND THE WORLD BANK

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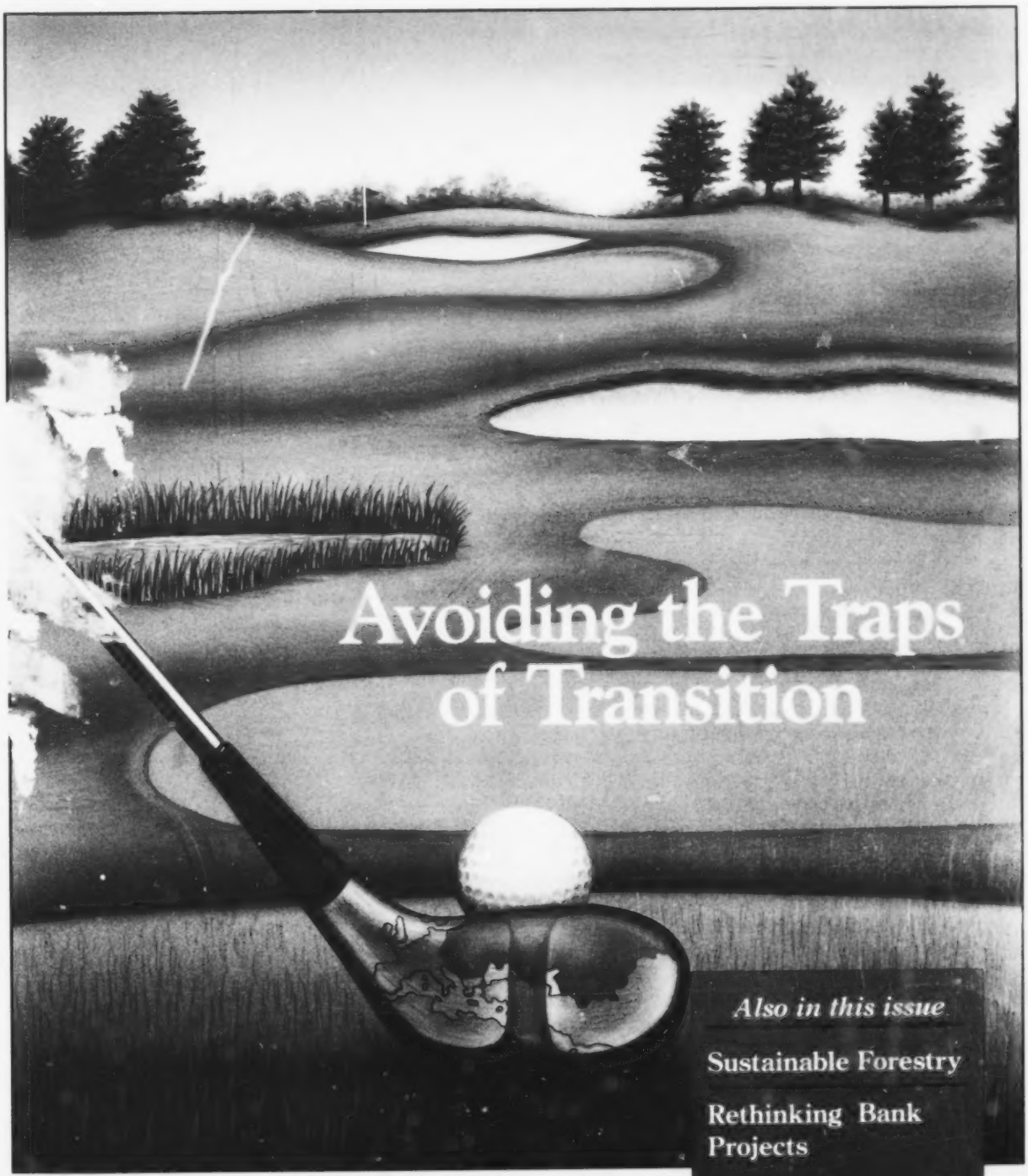

Avoiding the Traps of Transition

Also in this issue

Sustainable Forestry

Rethinking Bank Projects

Letter from the Editor

FOR MANY of the former centrally planned economies of Eastern and Central Europe, 1995 will mark the fifth year of transition to a market system. Other countries, notably the states of the former USSR, have embraced market-based economics more recently. These "economies in transition," seeking to define a new identity, are attempting to simultaneously restructure their economic systems, protect the well-being of their citizens, stabilize prices, achieve external balance, and revive output. But in the process, they face a difficult period of economic and political transition.

It is important to remember that the countries that are loosely called "economies in transition" are a rather diverse group. These countries—which include nations in Asia and Africa as well as Eastern and Central Europe—embarked on the transformation of their economies at different times. Moreover, their particular trade arrangements, productive structures, and sociopolitical characteristics have caused them to move through the transition in different ways. As the transition period lengthens, these differences take on greater importance in explaining why some countries have been more successful than others in reforming their economic systems.

The experience so far has shown that it takes much longer than anyone could have imagined to create the whole panoply of institutions that is required to make a market-based system function smoothly. Effective institutions are the foundation on which an economy rests; without them the reform effort cannot move forward. For example, tax reform may be thwarted if the administrative mechanisms to monitor and collect taxes are weak, and attempts to rein in government expenditure may fail if effective expenditure management systems are not in place. Privatization and bankruptcy legislation must be created, as well as an overall legal framework that fosters private sector activity.

Beyond the transformation of economic institutions, the main objective for transition economies must be to achieve and maintain high rates of economic growth. Sustained financial adjustment, as well as a bold reform agenda, are required to produce a macroeconomic environment conducive to achieving rapid growth and rising living standards. Trying to meet this double objective has at times generated tensions that have slowed the reform process. Nevertheless, experience has shown that a "stop-go" reform and adjustment policy combination may prove to be more painful in the long run.

The past five years have taught a great deal about the way institutions and policies have to be fashioned for a fully fledged market economy to emerge. We now have a better idea of what works and what does not. Completing the transition will be a long process, but through it those who have always lived under a market system, as well as those who have just embraced it, are learning some important lessons. This issue of *Finance & Development* highlights these lessons.

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What We Can Learn from the Soviet Collapse

WILLIAM EASTERLY AND STANLEY FISCHER

THE SOVIET experience teaches at least one cautionary lesson: development strategies emphasizing state-administered investment may produce rapid growth at first but are prone to eventual stagnation.

Why did the Soviet economic system prove nonviable after many years of growth? The economic crisis in the former Soviet republics since the collapse of the USSR in 1991 has understandably distracted attention from this retrospective question. The question may seem obvious in hindsight. Yet the sudden collapse of the system caught most people (including us) by surprise, cautioning us that the reasons for its downfall were not obvious before the fact. And the analysis of the collapse carries lessons for the development of all countries, including the former Soviet republics themselves.

While full-blown central planning has almost disappeared from the economic landscape, many countries' governments still attempt to influence the type and quantity of capital investment. Such attempts could be informed by a re-examination of growth through sheer force of capital accumulation. Our re-examination, drawing upon the large body of Western and Russian literature on the subject, reconfirmed many of the conclusions of this literature but also turned up two key surprises:

- Investment-led growth can be rapid at first then fall precipitately: following rapid pre-1960 growth, Soviet economic growth from 1960–87 was the worst in the world relative to investment and education rates—even lower than generally believed.
- Although the worsening performance of the Soviet economic system is usually attributed to its heavy reliance on capital accumulation, it turns out that a number of high-performing economies also relied heavily on capital accumulation. What was unusual about the Soviets' economic experiment was not the dependence on investment, or the low average return to investment, but rather the rigidity of the system that led to rapidly falling returns to investment.

Comparing growth rates

How did growth in the last decades of the USSR compare to growth in the rest of the world? Soviet economic growth per capita over 1960–89 was 2.4 percent, which was slightly above median world growth. This eminently respectable figure is based on the estimates of a generation of Western scholars such as Abram Bergson of Harvard University.

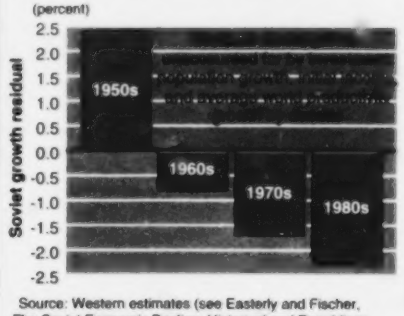
However, proper evaluation requires that we relate a country's performance—that is, its output—to quantity of inputs (such as capital investment). Stonehenge is a marvel because it was built with little in the way of capital equipment; we would be less impressed today if someone with heavy machinery took decades to line up a few stones. The Soviet growth performance no longer looks so satisfactory—or so worthwhile for Soviet citizens—once we realize that the Soviets had one of the highest investment rates in the world over 1960–89, yet had growth only at the global average.

We can go further in these international comparisons by utilizing the average statistical relationship for all countries between per capita growth performance and educational enrollments (good for growth), population growth (bad for per capita growth), and physical investment (good for growth). In fact, all of these factors should have been highly favorable for Soviet growth: in addition to its high investment rate, it had one of the highest secondary school enrollment ratios in the world and unusually low population growth.

Since Soviet growth was only average, there is in fact a large negative residual that we can attribute to the fact that the USSR was

Chart 1

Soviet growth: from good to bad to worse



Source: Western estimates (see Easterly and Fischer, *The Soviet Economic Decline: Historical and Republican Data*, 1994).

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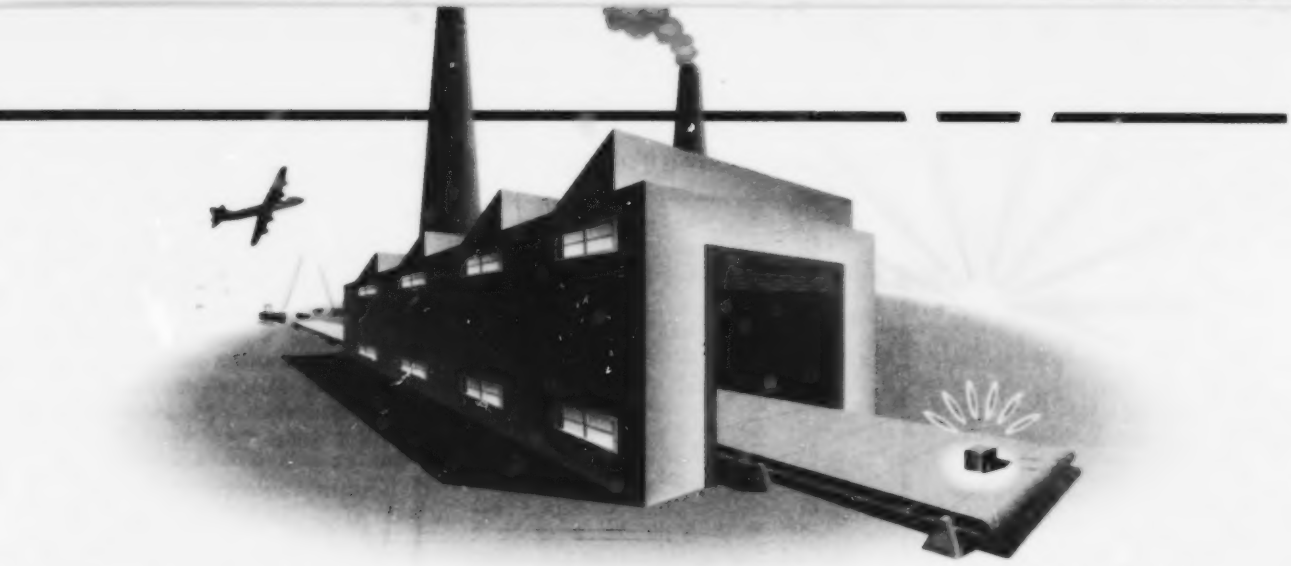


not a typical economy. Comparing the Soviet residual to other countries (controlling also for country size), we come up with a striking conclusion: the USSR has the largest negative growth residual, and hence was the world's most under-achieving economy, over 1960–89. Compared to how much consumption Soviet citizens had to give up to achieve high investment and education, the increase in output fell well short of international standards.

But this is not the end of the story, because Soviet growth was surprisingly good before 1960. If we repeat our growth residual exercise separately for each of the last four decades, we find that the Soviet growth residual was positive in the 1950s (Chart 1). Even taking into account the already high rate of investment in the 1950s, Soviet growth performance at that time was quite satisfactory. In fact, Soviet performance was so good in the 1950s that early growth theorists cited it as an example of how inefficient resource allocation does not affect the long-run growth rate. Economists like John Kenneth Galbraith predicted convergence of economic performance between East and West. But the Soviet growth residual became negative in the 1960s; Soviet growth then deteriorated further in the 1970s and 1980s. The Soviet growth residual shown here takes into account not only how Soviet growth compares to what should have resulted from the Soviets' high investment effort but also how Soviet growth compares to the world average growth during the same period. World average growth worsened in the 1970s and 1980s, but Soviet growth worsened even more, as shown by the increasingly negative residual.

In sum, Soviet economic growth was initially very satisfactory, then progressively deteriorated. Explaining why is more difficult than it would be if the Soviet economic system had always led to poor growth, which could have been attributed to inefficient and misallocated investment. Thus, we need to understand how the amount of growth coming from a given amount of investment worsened so markedly over time.

Defense, low morale

One popular idea is that the Soviet's increase in defense spending with Afghanistan and Star Wars from 1979–87 was the straw that broke the system's back. However, the data show that while higher defense outlays contributed to the Soviet slowdown, the quantitative impact was so modest as to be unimportant. Soviet defense expert Dmitri Steinberg estimates that this spending increase amounted to only 1.6 percentage points of GDP, and we can attribute only 0.15 percentage points of the growth slowdown over 1960–87 to increased defense outlays. The fact is that most of the long-run increase in Soviet defense spending occurred before 1960—that is, before the growth slowdown that we are trying to explain.

Another popular notion is that demoralization and a breakdown of discipline in the Soviet work force fed the Soviet collapse. Here, too, we find some evidence in the fact that surveys of Soviet emigres found the young to have been more dissatisfied than the old, a possible sign that the system was losing favor across generations. Alcohol consumption also rose sharply from the 1960s through the mid-1980s (when Gorbachev mounted an anti-drinking campaign), but rapidly growing countries have also had rises in alcohol consumption. The loss of morale was undoubtedly important, but must reflect, as well as be a cause of, slow growth.

Wrong type of growth

The most popular hypothesis for the Soviets' growth deterioration in the economics literature is the extensive growth hypothesis: that the Soviets relied too heavily on capital accumulation as a source of growth. According to classic economic theory, higher growth in capital than in other inputs like labor will lead to diminishing returns to capital in which output growth will fall over time even if capital growth is maintained. The definition of extensive growth is growth in which the capital stock increases faster than output. The ratio of the Soviet capital stock to output has indeed risen dramatically over time—about 2.5 percent per annum over 1950–87—which supports the conventional wisdom that the Soviets relied on extensive growth.

There is one problem, however, with the conventional wisdom. Contrary to the conventional view, the Soviets' rising capital-output ratio is not unusual: many countries have rising capital-output ratios. Moreover, the most successful economies in the postwar period are among those with extensive growth. Jong-il Kim and Lawrence Lau of Stanford University have estimated that Japan, the Republic of Korea, and Taiwan Province of China had rates of increase in capital-output ratios of over 3 percent per annum over 1960–90, which exceeds the Soviet increase over the same period. Alwyn Young of MIT has similar findings for these economies and adds Singapore to the list of countries with extensive growth. What makes the Soviet experience unusual was not the extensive growth itself, but the low payoff to extensive growth.

Why did one set of economies with extensive growth become the East Asian Miracle, while another economy with extensive growth became the Soviet Collapse? Martin Weitzman of Harvard University suggested many years ago an arcane but important reason. In market economies, capital (e.g., machinery and equipment) can substitute rather easily for labor and thus sustain growth for long periods even when the labor force is not growing. Growth would still slow down eventually, but much less dramatically, as long as the ease of substi-

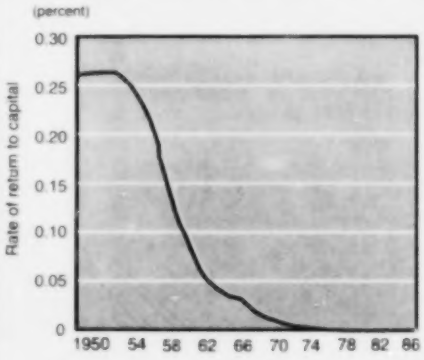
tution is high. Using data on output, capital stocks, and labor employed to estimate a production function, we can calculate this ease of substitution in the USSR as well as in market economies.

Weitzman found, and we have confirmed with more recent data, that capital was an extraordinarily poor substitute for labor in the USSR. In market economies, the ease of substitution was high—machines could replace labor and thus make it possible for each worker to produce what might have earlier taken, say, two workers. But the Soviet economy seemed to be constrained by technology that almost required unchanging proportions over time: one machine, one worker.

We can now understand why Soviet growth was rapid early on, then declined so precipitously. In the beginning, capital was scarce: not all workers had machines. Giving a machine to a worker without one would have a very high payoff; the payoff will stay high as long as there are workers without machines. Eventually, however, all workers will have machines and the returns to additional machines will fall off to virtually nothing. This is exactly the pattern we see in the Soviet industrial sector, where we have estimated the return to capital since 1950 (Chart 2). The rate of return to capital was high and constant in the 1950's during the period of rapid growth. But with the saturation of the labor force with capital, a precipitous decline in returns set in after 1960; by the mid-1970s, the return to new investment in Soviet industry was essentially zero. We find a similar pattern for the rest of the Soviet economy.

Chart 2

Soviet capital: from high payoff to none



Source: Western estimates of capital stocks, employment, and value added in industry (see Easterly and Fischer, *The Soviet Economic Decline: Historical and Republican Data*, 1994).

Why the payoff fell

Why is it that capital could replace labor relatively easily in market economies, while the Soviets were stuck with an almost fixed proportions economy? We can speculate, although more research is needed. Consider the following parable. Planners in a system like that of the USSR need to determine the kind and amount of capital good that will go to each enterprise under their jurisdiction. The planners may have some feedback from the enterprise on the desired type of capital good, but the sheer scope of the planning job makes it difficult to incorporate very much enterprise feedback into the capital allocation decision. The planners will probably prefer some homogeneous collection of capital goods that are easy to count, and hence to allocate among the enterprises. A narrow range of terms of capital goods will also make it easier for the central authorities to keep abreast of the relevant technological knowledge. The end result is that planners limit themselves to a small number of types of capital goods—tractors, drill presses, etc. (Similarly, for human capital accumulation, planners dictate narrow and rigid educational specialties for workers and technicians.) In our parable, only one type of machine is available, so investment merely involves giving machines to more and more workers until all workers have them.

In market economies, we have a contrasting parable. Students of growth such as Paul Romer of the University of California at Berkeley, Gene Grossman of Princeton University, and Elhanan Helpman of Tel Aviv University stress the key role that the increasing variety of capital goods plays in sustaining growth in market economies. Decentralized managers demand—and capital goods producers supply—an incredible array of different types of capital goods in response to profit incentives, an array of goods that would be far beyond the capacity of planners to allocate or monitor. In market economies, when the possibility of replacing labor with one type of capital good is exhausted, enterprises shift to another. Market incentives lead to the exploration of an enormous range of capital goods that could be useful in production (including great flexibility and range in terms of human capital with broad-based educational training). It was a lot easier for market economies to substitute for a worker a numerically controlled drill press, skills training in numerical control, and a computerized inventory control system, than it was for the Soviets to substitute simply another drill press for a worker.

What is the lesson? It has always been understood that investment imposed from above could have low returns because political pressures or inadequate information lead to poor allocation decisions. The Soviet case shows the additional, and less well-understood, lesson that the returns to such investment could also fall precipitously as governments continue investing in increasingly outmoded types of capital goods whose labor-saving potential quickly becomes exhausted. It is easy to understand how governments can make the mistake of imposing—and continuing—excessive control of investment, since such a strategy may lead at first to rapid growth when the types of capital favored by government are initially scarce.

Quality counts

Along with the caution about declining returns to government-controlled investment, the Soviet experience also shows that high investment alone is not sufficient to generate rapid growth, which is even more obvious in Soviet Central Asia (see box). This is a useful corrective to the sometimes excessive emphasis on the quantity—rather than the quality—of investment in development policy discussions.

Other research also suggests that the sheer quantity of capital accumulation does not explain all that much of cross-country growth differences. The classic growth accounting study of Nobel Laureate Robert Solow in the 1950s made the famous point that physical capital accumulation accounted for no more than a quarter of industrial country growth. A recent growth accounting exercise by Ross Levine of the World Bank and Robert King of the University of Virginia found that the quantity of capital accumulation only accounted for about 40 percent of the growth of developing countries. More controversially, researchers Magnus Blomstrom, Robert Lipsey, and Mario Zejan have suggested in a recent National Bureau of Economic Research study that growth may cause investment rather than investment causing growth. Many old and new views of growth suggest that the process of adopting more advanced technology—a process very sensitive to the economic incentives facing firms—is the key to growth.

Policymakers facing depressed growth are often tempted to increase investment by increasing the government's own capital accumulation. In fact, Soviet reformers first responded to depressed growth in the mid-1980s by increasing state enterprise investment. As we know, this response was not successful in avoiding the deepening systemic crisis. The same temptation exists today in many of the former Soviet republics.

Although the role of investment in growth remains controversial, we are probably safe in concluding that excessive fixation on the quantity of physical investment to GDP is not

Why so grim in Soviet Central Asia?

If the Soviet Union as a whole dramatizes that economies do not grow through investment alone and state-directed investment is particularly unrewarding, Soviet Central Asia is the most extreme dramatization of all.

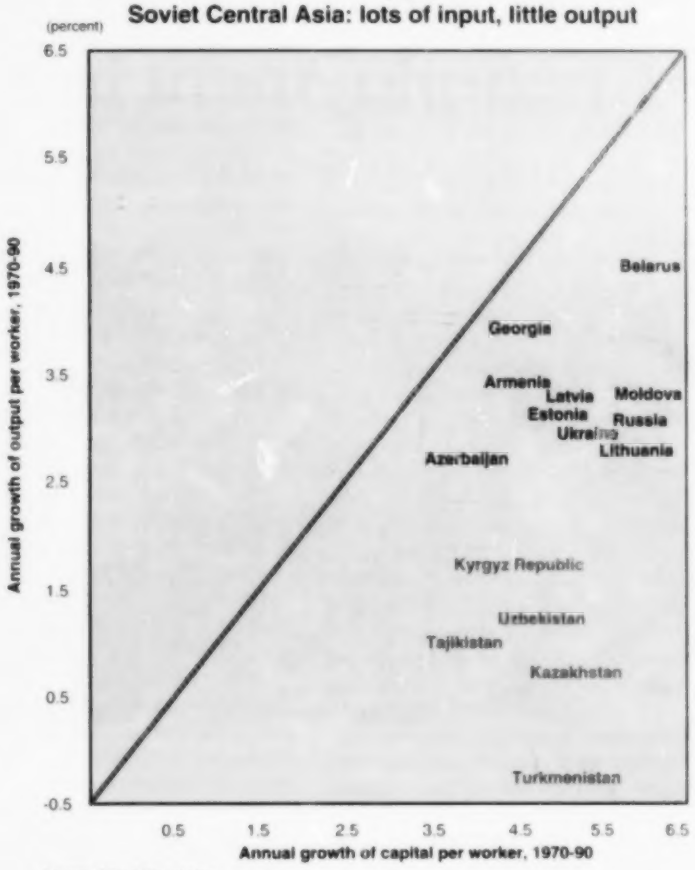
The Central Asian republics had minimal growth in output per worker despite strong growth in capital per worker over 1970–90, according to optimistic official data (Chart 3). Individual sectors are even more striking; over 1970–90, Turkmenistan's industrial output per worker fell at 1 percent per annum despite capital per worker growth of 6 percent per annum; Uzbekistan's agricultural output per worker fell at 2 percent per annum despite capital per worker growth of 5 percent per annum.

Why such a poor performance? One reason was the ill-considered attempts by the government of the USSR to have those republics emphasize products in which they were uncompetitive. Perhaps the most notorious instance was the attempt at irrigated cotton production that poisoned the soil, shrank the Aral Sea, and produced disappointingly little cotton. More generally, the Central Asian republics had much larger shares of agriculture in employment than would have been expected given their per capita income levels and natural endowments. Indeed, examining data across sectors and republics shows a statistical association between this kind of sectoral disproportion and poor total factor productivity growth.

Another key reason was the low educational attainment, a factor that crops up frequently in international studies of comparative growth performance. As a ratio to total population, the faster-growing republics to the west had almost twice as many specialists with higher education as Soviet Central Asia.

Chart 3

Soviet Central Asia: lots of input, little output



Source: Official Soviet data.

a useful guide to policy. Artificial increases in investment—such as increases in investment by state enterprises—do not necessarily increase growth. The proper response to depressed growth is to create a policy environment that fosters overall productivity growth, technology adoption, and high-quality private investment. The state can play a supporting role by supplying long-term public goods like infrastructure, environmental protection, and health care—a role that planned systems played poorly.

Gur Ofer of Hebrew University insightfully argued that the Soviet system was characterized by haste, in which Soviet managers tried to achieve short-term output increases to meet plan targets, but neglected long-term needs like adequate infrastructure and environmental preservation. This short-term bias was also true of Soviet human capital accumulation. One of the more troubling developments under the old system, was the deterioration in the health care system. This deterioration, among other factors, contributed to a startling decrease in male life expectancy beginning in the 1970s, at the same time as other countries at all income levels were realizing increases in life expectancy.

The haste bias helps explain why the quality of Soviet investment was low; it has also left the states of the former USSR with an unfortunate legacy of infrastructural and environmental crises, as is only too well known. Reversing the neglect of these long-term needs will require the governments of the successor states to engage in investment in these areas.

Could it have been different?

Looking back it is tempting to believe that the system could have been reformed successfully if it had started earlier, say in the 1960s. But remember that the Kosygin reforms in the 1960s did not succeed in reversing the growth slowdown. The flaw of the Soviet central planning system—a flaw that is likely shared by any heavily state-managed economy—was that it did only a very few things well. It was inevitable that severe diminishing returns would set in as the system kept doing more of the same.

The lessons from the Soviet experience seem particularly relevant for countries whose governments heavily control the type and quantity of investment—including the states of the former Soviet Union. Such governments will often be far more successful at achieving a high quantity of investment than a high quality. The Soviet economic experience of 1950–89 gives an almost clinical demonstration that a high quantity of investment is not sufficient to sustain growth for very long. The more subtle lesson is that heavy state intervention in the economy may achieve increases in growth in the short run, only to lead to stagnation in the long run. ■

For further detail, see the authors' "The Soviet Economic Decline: Historical and Republican Data," World Bank Working Paper 1284, April 1994, also available as National Bureau of Economic Research Working Paper 4735, May 1994.

Unemployment in Eastern Europe

OLIVIER BLANCHARD, SIMON COMMANDER, AND FABRIZIO CORICELLI

WHILE unemployment is the natural outcome of the process of reallocation and restructuring in the economies in transition, there is a legitimate concern that high and persistent joblessness will hamper further reform efforts. Understanding the dynamics and nature of unemployment in these economies is essential for developing policies that are consistent with furthering reform, yet cope with the problems associated with large declines in employment.

In only a few years, unemployment has become one of the most pressing issues facing the transition economies in Eastern Europe and increasingly in the states of the former Soviet Union as well. As of early 1994, 10–15 percent of the labor force in Eastern Europe lacked work, and over 40 percent of the unemployed had been jobless for more than a year (Table 1). The significance of this development cannot be overstated. Under central planning, workers were virtually guaranteed full employment. This was achieved by placing workers on the payrolls of state enterprises, which were, as a result, chronically overstaffed and unproductive. With the collapse of central planning, however, the objective of maintaining full employment was abandoned, and, for the first time in decades, large numbers of people found themselves out of work.

While unemployment is a necessary result of the resource reallocation that must occur as state-owned enterprises are privatized and restructured, the high levels of unemployment that are now observed have increasingly emerged as an obstacle to restructuring. Indeed, the economic and political costs of high unem-

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ployment have affected the overall reform process, slowing the restructuring of the state sector and discrediting reform-minded governments. Thus, the rate of growth of unemployment and, in particular, ensuring that the long-term unemployed are brought back into the active labor force has become a major concern for economies in transition.

Patterns of joblessness

Unemployment has primarily been driven by reductions in employment in the state sector. Unemployment would have been even higher if it were not for large flows out of the labor force, which partly reflects the reversal of the artificially high labor force participation rate—particularly for women—that was a characteristic of the planned economy. One way of thinking about this evolution is that, in theory, as people lost their jobs in the state sector and unemployment rose, wages would fall, and with this decline, the incentives for the private sector to create jobs would grow. This has indeed happened, but with several important qualifications.

The flow into unemployment has been low relative to OECD comparators, however, the flow out of unemployment has been lower still. Once workers become unemployed, they have great difficulty finding a job. Thus over time, unemployment has become like a stagnant pool with new entrants trickling in but with few exiting. In Poland or Hungary today, less than 3 percent of the unemployed find jobs each month (the monthly exit rate); by comparison, the rate in the United States in 1992 was nearly 25 percent.

Unemployment: the long wait

Why has unemployment remained high? A number of explanations have been put forward.

- Workers commonly search for and find other jobs while still employed;
- Employers may prefer "job-to-job" transitions believing that they can select better quality workers among those already employed rather than among the unemployed, about whom they have imprecise information;
- Workers who remain unemployed for long periods tend to become discouraged and give up looking for work;
- Duration and levels of benefits are too high, deterring the unemployed from looking for work. This explanation may not be valid, however, because eligibility has been universally tightened over time—for example, the Czech and Slovak Republics now provide benefits for only six months—while the ratio of benefits to the worker's last wage (the replacement rate) has also been reduced. The fact that benefits are not generous suggests that, on average, they are unlikely to have been a powerful factor in restraining job search by the unemployed; and
- There appears to be a major imbalance in the distribution of the unemployed and vacancies across regions. This geographic mismatch—exacerbated by constraints on mobility, including a poorly functioning housing market—has led to severe inefficiencies in matching workers with jobs.

This last point is especially significant. It partly reflects the effect of earlier decisions on the structure and location of industry. Regional concentration in output and employment and the associated phenomenon of the one-company or industry town—particularly important in Russia—has been a significant factor in these regional imbalances. Faced with new relative prices and competition, these industries and towns have declined, and the shocks to local employment have been profound. For example, this has been the case for military producers in the Slovak Republic, and heavy industry in northeast Hungary. Similarly, rural areas throughout Eastern Europe have continued to experience high unemployment. The growth of jobs in the private sector has not compensated for these shocks to any great extent so far.

Reducing unemployment requires creating jobs in the private sector, particularly as one can expect further employment losses from privatized firms as they restructure, as well as from the remaining state-owned firms. Understanding the behavior of enterprises, especially with regard to wage and employment decisions, is thus essential for determining the likely future rise of employment in these economies.

Table 1

Rising unemployment in economies in transition

Unemployment rates
(period averages)

	1990	1991	1992	1993	1994 (first quarter)
Bulgaria	1.6	11.9	14.0	15.5	16.1
Czech Republic	0.7	4.2	2.6	3.2	3.7
Hungary	1.5	7.8	14.0	13.7	12.5
Poland	6.1	11.5	15.5	15.0	16.0
Romania	--	3.0	8.3	9.5	10.1
Russia	--	--	1.1	1.4	2.1
Slovak Republic	1.5	6.6	11.4	14.4	15.7

Source: *Unemployment, Restructuring and the Labor Market in Eastern Europe and Russia*, World Bank, 1994.
-- Data not available.

Enterprise behavior

The way unemployment has evolved is primarily the result of the asymmetric behavior of state and private firms in their employment decisions. So far, job losses in the state sector have been much greater than the number of jobs created by the private sector. Moreover, the level of unemployment itself has had an important impact on the behavior of firms.

State firms. When the transition to a market-based economic system began, state firms moved slowly to reduce their work forces, relying primarily on attrition, early retirement, and other voluntary measures. Only where the shocks to the economy were sufficiently large, as in Bulgaria, did involuntary separations figure significantly early in the transition process. A second phase, in which involuntary separations increased, was largely attributable to reductions in credit to state firms, announcements of changes in ownership, and the growing autonomy of managers. Surprisingly, the evidence from Eastern Europe suggests that firms in general have operated *ex ante* as if facing a hard budget constraint. Even when subsidies and other forms of support have been maintained, as in Romania and Russia, there have still been clear declines in employment.

Nevertheless, avoiding or limiting layoffs has remained an important objective for both managers and workers in state firms. For instance, evidence from Romania shows that those industries receiving subsidies and other assistance adjusted employment the least. These protected industries also experienced relative wage increases. Further, even when unions or other labor organizations have exercised little direct say in firms' decisions, their implicit voice may not have been small.

Evidence from a number of countries—Bulgaria, Poland, Romania, and the Slovak Republic—suggests that the process of employment reduction is by no means linear. Phases of increased layoffs have been followed by episodes of "labor hoarding." This appears to be explained primarily by political factors, as governments—sensitive to high national or regional unemployment rates—have selectively sanctioned labor hoarding by relaxing financial constraints. This has often been done not by explicitly increasing subsidies to firms—these have declined very significantly almost everywhere—but by facilitating credits from the banking system to heavily indebted firms. In Hungary, for example, this practice has subsequently required large, repeated

Why unemployment rates differ

Aggregate unemployment rates mask significant changes over time and across regions. Indeed, unemployment rates vary widely among economies in transition and are directly related to how much employment in the state sector has fallen and to job creation in the private sector. Constraints on labor mobility accentuate the difference among countries.

Table 2 puts employment and unemployment changes together, and shows the ratio of the change in unemployment to the absolute value of the change in employment. Under the benchmark case of no change in working age population, and all workers going from employment to unemployment, the ratio is equal to 1. Values much below 1 indicate that much of the employment decline has translated into nonparticipation rather than unemployment.

Consider first the three major Central European countries, Poland, Hungary, and the Czech Republic. The table suggests two proximate reasons for the lower unemployment rate in the Czech Republic. The first is a larger offset of the decline in state employment by private sector growth. The second is a much lower ratio of the change in unemployment to the change in employment. Tough unemployment eligibility rules clearly have led many more workers in the Czech Republic to become nonparticipants rather than unemployed. And the labor force participation rate at the start of transition was the highest in Eastern Europe. In Poland by contrast, the ratio is greater than 1, indicating that, despite the importance of early retirement soon after the transition, much of the decrease in employment since then has translated into unemployment rather than non-participation. Were the Czech Republic to have the same ratio as Poland, the unemployment rate would be close to 8 percent. Were the Czech Republic to have the same ratio as the Slovak Republic, the rate would be close to 7 percent, compared to 11.6 percent for the Slovak Republic. Thus, unemployment is lower in the Czech Republic because of both stronger private employment growth and a larger increase in nonparticipation. In Bulgaria, the primary cause of high unemployment is the combination of large losses in state employment and a struggling private sector. A large part of the employment decline has translated into nonparticipation. Were Bulgaria to have a ratio of 1 rather than 0.5, its unemployment rate would be close to 30 percent.

A third pattern, seen in Romania and Russia, was continued low unemployment at the start of the transition, primarily because of the smaller decline in state employment and smaller increase in private employment. In Russia, the ratio of unemployment to employment changes is again very low; were it equal to 1, the unemployment rate would stand around 4 percent. The subsequent increase in Romania in 1992 and Russia in 1994 reflects some tightening of the budget constraint, although policy changes have been frequent and unpredictable.

Table 2

Changes in employment and unemployment across regions

(percent)

	Change in total employment	Change in state employment	Change in private employment	Change in unemployment	Ratio change in unemployment/ employment
Bulgaria	-24.0	-34.7	10.7	14.0	0.6
Czech Republic	-11.5	-32.3	20.2	2.5	0.2
Hungary	-12.6	-33.8	21.2	14.1	1.1
Poland	-12.6	-20.3	7.7	14.2	1.1
Romania	-5.9	-9.9	4.0	6.5	1.1
Russia	-4.1	-17.9	13.8	1.4	0.3
Slovak Republic	-12.4	-22.2	9.8	10.4	0.9

Source: *Unemployment, Restructuring and the Labor Market in Eastern Europe and Russia*, World Bank, 1994.

Note: The data compare employment/unemployment rates in 1992 with rates at the beginning of the transition period—1989 for Poland and 1990 for other countries. Ratio is the change in unemployment to the negative of the change in employment.

government bail-outs of the financial system. In addition, tax relief, toleration of nonpayment of social security contributions, and other mechanisms have been used to support state firms.

Although the process has been uneven, state firms have shed labor, and often on a major scale. Many of those workers who lost their jobs either left the labor force entirely or found new jobs directly. The rest became unemployed. But unemployment (or its political fall-out), in turn, has affected the rate of jobless in the state sector, so that as unemployment rose, labor shedding by state-owned firms tended to decrease.

It is still too soon to assess the implications for unemployment of privatizing major parts of the state-owned enterprise sector. Even in the Czech Republic, where the first phase of voucher privatization has been completed, a very small number of bankruptcies have resulted, and restructuring has remained small. However, given the extensive restructuring that would likely be required to make many formerly state-owned firms viable, privatization, whether from above, as in the Czech case, or more commonly, from below, respecting the rights of workers, is likely to entail further employment losses. This can arise from active restructuring decisions or equally from the response of firms to a difficult financing environment and inability to attract outside investors—a particular problem when firms have been privatized by insiders. Indeed, the cost of restructuring the privatized firms remains a major obstacle in almost all countries.

Private firms. The private sector has generally grown significantly, and not simply as a result of privatization. The relative rate of expansion of the private sector has been closely related to the rate at which the state sector has declined. Where there has been policy ambiguity or where maintaining the state sector has been given priority—as in Romania—growth in private firms has clearly been held back. Private sector growth has also been held back in Bulgaria, but for rather different reasons. In Bulgaria, both output and employment in the state sector declined drastically because of the size of the initial output shock, which was magnified by a large fiscal correction and associated deflationary policies. These effects hit the whole economy, limiting the growth of private firms. In other countries, such as the Czech Republic, Hungary, and Poland, private sector growth in output and employment has been substantial. But in all countries, private sector growth thus far has largely come from filling the gaps, particularly in services, that were inherited from the previous system. This can be viewed as a once-and-for-all adjustment and, as such, it raises the difficult question of whether much more growth from this part of the private sector can be expected.

The path of wages

The employment level that these economies ultimately attain will be sensitive to the evolution of wages. At the start of the transition many feared that, freed from earlier constraints and given uncertainties over ownership, those who still had jobs would behave short-sightedly, and push for aggressive wage settlements. This has not happened to any

great extent. But despite large declines following price liberalization, over time, real wages have been recovering. Unit labor costs, which measure wage costs per unit of output, show a clear increase over pre-transition levels. Part of this may reflect declining output and continued overstaffing in state firms. However, as profits in the state sector have generally evaporated, the evolution of unit labor costs may also reflect the ability of insiders—those still employed—to set wages higher than would be warranted in a competitive setting. Even so, it is hard to attribute much of the employment losses to date to selfish and expansive wage behavior by those still working. However, it is clearly important that wage restraint remain a characteristic of transition, for without it, employment would be lower.

Wage setting in state and privatized firms is also very important because of the interaction between wages in such firms and the wages offered by the private sector. For instance, if wages remain higher in the former, this differential wage will likely feed back to private sector wages and, ultimately (negatively), to employment. Until now, the available data indicate that private sector wages are generally lower than in state firms. However, the private sector appears to have several constituent parts; a larger low-skill, low-wage end (primarily in services), as well as a much smaller, high-wage component. The fact that wages in the private sector are not higher, on average, provides little incentive for workers to quit the state sector.

Quite striking is the evidence reported for almost all of the countries surveyed; workers, including those unemployed, generally express a preference for state employment. In the case of the unemployed, it may be a result of their attaching a low probability to finding a private sector job, but more generally it reflects the perception that job conditions, including wages and benefits, are superior in the state sector. And, of course, there is the legacy of values and expectations from the planned economy. These factors have generally combined to ensure that the decline of the state sector has been more gradual than initially expected and that insiders have also managed to preserve their privileges.

Hard realities

The recent experience of unemployment in Eastern Europe and the states of the former Soviet Union has been diverse and prospects are mixed. In some cases—Russia and Romania are the most obvious examples—the break with the soft budget constraint has yet to be achieved and macroeconomic instability has resulted. In these countries, unemployment has only begun to emerge. And in almost all cases, unemployment to date has mainly been driven by macroeconomic shocks, suggesting that the restructuring necessary to transform the economy to a market-based system will bring further job losses.

In countries where reforms are more advanced, there is still a common fear that the private sector may not be able to create employment on a scale required for robust economic growth. In addition, unemployment may stay high as regional imbalances become entrenched and many of the unemployed become too discouraged to continue seeking work. In such cases, the political viability of reform may be compromised, as well as the fiscal stance of the government because of the cost of providing additional benefits to the unemployed.

"In countries where reforms are more advanced, there is still a common fear that the private sector may not be able to create employment on a scale required for robust economic growth."

While such a scenario seems unlikely, at least in the Czech Republic, Hungary, and Poland, much depends on whether unemployment effectively triggers lower wage claims as workers seek to preserve their jobs in the state sector. If this occurs—and here the evidence is still fragmentary—downward pressure on wages should promote job creation in the private sector. Further, with privatization and restructuring, deteriorating employment options will likely result in slower restructuring in state or privatizing firms, rather than an increase in unemployment. This can, however, cut two ways. In Bulgaria, for example, the sharp initial jump in unemployment was not accompanied by any coherent program of privatization. Restructuring of state firms likewise dwindled, but financial supports were made available to arrest further growth in open unemployment. In turn, this acted as a brake on the growth of the private sector as well as provoking a deterioration in government finances. And a more general danger is that in countries where the state sector remains large, wage and employment decisions will be taken consistent with the old "guaranteed employment" mentality that prevailed under central planning. These effects will, of course, be magnified if many of the unemployed have been out of work for a long time and may no longer be seriously searching for jobs. As in OECD countries, such so-called duration effects can weaken the impact of unemployment on wages, with possibly severe long-run consequences for the overall level of employment.

In this context, policymakers need to face some hard realities:

- First, it is important to recognize that high unemployment has occurred alongside limited restructuring and reallocation of resources. There is more unemployment to come.
- Second, unemployment varies widely among regions in all countries. This is partly because of barriers to mobility, such as housing. But it also suggests a possible role for infrastructural projects that can increase mobility. Stimulating a housing market and improving infrastructure will take time, however, and the benefits are unlikely to be seen quickly. In addition, mechanisms and financing for the transfer of social benefits provided by firms to local governments—a major feature in Russia—need to be put in place. Without these reforms, firms will hesitate to release labor, and workers will lack appropriate access to services outside of firms.
- Third, by end-1994 over half the unemployed will be long-term unemployed with few chances of recovering a job. It is important to reduce the share of the long-term unemployed. Only in the Czech Republic have significant steps been taken to adopt active labor market programs, including training and wage subsidies for hiring the unemployed. Elsewhere, fiscal and institutional constraints on implementing active labor market policies have prevailed. Shifting the balance toward a larger active component will be desirable and schemes—such as marginal wage subsidies—that encourage employers to hire from the pool of unemployed can help in breaking the cycle of long-run joblessness, even if they impose additional short-run costs.
- Finally, policies that respond to unemployment by simply postponing restructuring and going slow on ownership reform in the state sector may yield short-run political benefits. But these are also likely to have other less desirable effects that may paradoxically result in the longer term in a lower level of employment. ■

A longer version of the paper by the authors can be found in Unemployment, Restructuring and the Labor Market in Eastern Europe and Russia, *World Bank*, 1994.

Fiscal Policy in Transition Economies: A Major Challenge

GEORGE KOPITS AND ERIK OFFERDAL

DESIGNING and implementing fiscal policy in transition economies is a major challenge. A balance must be struck between sometimes conflicting goals. In the process of fundamental institutional change, economies in transition face both severe economic and social dislocations, and widening macroeconomic imbalances. Because of the central role of the state in these economies, fiscal policy is key in the double effort to stabilize the economy and to move toward a market-based system.

Fiscal policy has been at the center of the economic reform programs pursued by economies in transition. Under central planning, resource allocation was decided by the state. Since the state controlled virtually everything, public finance was all-encompassing and involved massive discretionary intervention in the economy through—among other things—direct transfers to nonfinancial, state-owned enterprises (SOEs), price subsidies, and social benefits. This intervention was financed by countless variable turnover taxes and payroll taxes, all differentiated by industrial activity or earmarked at the enterprise level. In turn, the SOEs and the banking system supported the goals of central planning by directly or indirectly subsidizing employment, consumption, and investment under a soft budget constraint—including protection from bankruptcy risk.

Structural and institutional reform is an important priority, yet these economies also have had to cope with severe short-term macroeconomic imbalances, characterized by high inflation and plummeting output. Thus, the programs that they followed, including their fiscal content, aimed at *both* macroeconomic stabilization and market-oriented structural reform.

A recent IMF study, covering the experience of eight formerly centrally planned economies with IMF-supported adjustment programs during 1990–93, found that the need to achieve macroeconomic stability while at the same time pressing forward with reform of deep-seated structural distortions often led to conflicts between *quality* and *quantity* of fiscal adjustment (for country coverage see table). The study shows that transition economies have each responded in their own way, and some have made more progress than others. However, instead of slowing down the reform effort, this conflict can only be eased by reforming the budget process, by reordering expenditure priorities, revamping the tax system, and restructuring and privatizing the SOEs and the banking system.

Adjustment and reform

The fiscal adjustment and reform tasks faced by transition economies resemble in many respects those that are familiar to a number of more market-oriented economies—taming high inflation and balance of payments deficits, eliminating structural distortions, and reversing low domestic savings, poor investment performance, and economic stagnation. However, the adjustment programs in transition economies stand apart in three important respects:

- These economies have been experiencing *both* high inflation and a dramatic fall in economic activity—unprecedented in modern times in depth and duration. These macroeconomic imbalances occurred in connection with the transformation from central planning to a market system, and have posed an extraordinary additional burden on the adjustment process.
- The economies in transition are engaged in a major effort to redefine the functions of government; an effort that goes far beyond correcting the distortions in resource allocation afflicting some market economies. The all-encompassing role of the state as regulator of economic activity and virtual sole proprietor must be cut back drastically, so that the government's only involvement is in the provision of social services and public goods.
- The quasi-fiscal activities of the SOEs and the banking system, quite extensive in all economies in transition, should be placed in the sphere of traditional government operations—and these operations should also encompass the social security system. Before the separation of functions between the government, the enterprise sector, and the banking sector is complete, these activities have to

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be abandoned or absorbed into the government budget. Only then can SOEs be expected to operate along commercial lines under a hard budget constraint.

Quite apart from differences between adjustment programs in transition economies and those of market economies, there are some critical differences among the transition economies themselves. These differences, which significantly influenced the shape of the adjustment program pursued in each country covered by the IMF study, were:

- the extent of prior market-oriented institutional reform, the most advanced stage having been attained in Hungary and Poland.
- the initial macroeconomic disequilibrium, which was most pronounced in Poland and probably least acute in the former Czechoslovakia.
- previous involvement in the former Council of Mutual Economic Assistance (CMEA) trade, with the heaviest dependence by Bulgaria and Mongolia.
- the resource base and level of industrial development, with Algeria being well endowed with hydrocarbon resources, while the Lao P.D.R. and Mongolia have the narrowest resource base and are the least developed.
- demographic pressures, which are especially adverse in Algeria, Bulgaria, and Hungary, as reflected in a high population growth rate in Algeria, and high and increasing old-age dependency ratios in the other two countries.

Another crucial determinant of the success of the transition has been the governments' resolve—underpinned by a sufficiently broad popular consensus—to overhaul fiscal institutions and to eliminate the fiscal imbalance. Understandably, the intensity of this resolve and of popular support for the reform have fluctuated within each country over time and have varied widely across countries. Yet, in most of the economies in transition covered by the study, the future role of government in the economy has yet to be defined.

Tailor-made adjustment

A major implication of these characteristics for adjustment programs is the need to address two distinct—albeit interwoven—goals: to carry out a broadly defined fiscal adjustment—that also includes the SOEs and the banking system—to get the economy back on track at a minimum output cost; and to create basic market-based institutions and practices in the fiscal area (e.g., taxation and budget process), as well as in other related areas (e.g., property rights, banking, accounting, and bankruptcy). Naturally, the pursuit of these goals had to be tailor-made to the particular circumstances of each country. A summary of the fiscal content of these programs in the countries covered by the study is presented in the table.

The overall picture that emerges from the experience of these countries is that, at the beginning of the transition, there was scope for a substantial fiscal adjustment both in quantity and quality. Most countries accom-

Fiscal measures were wide ranging[1]

	Algeria	Bulgaria	Former Czechoslovakia	Hungary	Lao P.D.R.	Mongolia	Poland	Romania
Tax-based incomes policy for state-owned enterprises[4]		x	x	x			x[2]	x
Tax reform								
Simplification of turnover tax			x		x	x	x	
Value-added tax and excises	x	x		x[2]				x
Personal income tax	x	x	x	x[2]			x	
Enterprise profit tax	x	x	x	x[2]	x	x	x[2]	x
Dividend requirement for state-owned enterprises				x			x	
Import surcharge	x		x			x	x	
Elimination of subsidies and transfers								
Consumer and producer subsidies	x	x	x	x			x	x
Housing subsidies			x	x				
Transfers to state-owned enterprises		x	x	x		x	x	
Expenditure management								
Improvement in budget monitoring/control	x		x	x	x	x		
Cash rationing of expenditure		x				x	x	
Reduction of extrabudgetary operations	x				x		x	
Social security reform								
Pensions		x		x		x	x	
Unemployment compensation		x	x	x			x	x
Sick pay				x				
Social assistance	x	x		x		x	x	x
State-owned enterprises								
Restructuring	x			x	x			
Enforcement of bankruptcy				x			x	
Privatization		x	x	x	x	x	x	x
Banking system								
Reduction of subsidized credits		x	x	x	x	x	x	
Bank recapitalization	x	x	x	x			x	x

Source: International Monetary Fund.

[1] Fiscal measures included in 1990–93 economic adjustment programs.

[2] Reform measures had already been undertaken in many of the countries indicated here prior to the 1990 adjustment program.

plished a relatively successful correction of the initial fiscal imbalance, and this helped to significantly dampen inflation expectations. Notably, in Poland the budget swung from a deficit of 4.6 percent of GDP in 1989 to a surplus of 2.7 percent of GDP in 1990, a correction of more than 7 percentage points of GDP, while the improvement in the fiscal position in Algeria, Bulgaria, and the former Czechoslovakia ranged from 5 to 7 percentage points of GDP in the first year of adjustment (1991). As an exception, Romania started from a surplus position—mainly due to transfers from SOEs to the budget—that evaporated rapidly after 1990.

In the course of 1991, however, several countries were hit hard by the collapse of the CMEA, worsening terms of trade, and the concomitant output contraction, which contributed to a significant fall in government revenue. But more important, after the initial success in taming the budget deficit, structurally sound and socially necessary fiscal measures became less compatible with the short-run stabilization objective. For example, streamlining the enterprise profit tax—in tandem with the reduction in budget transfers to enterprises—contributed to the deterioration in the fiscal position and endangered the stabilization goal. Also, worsening measured budget deficits reflected a cleanup of the fiscal accounts—the incorporation of the cost of quasi-fiscal operations in the SOEs and banking sector into the budget. This cleanup applied to the extension of unemployment compensation plus other social benefits previously provided by SOEs; payment of market-based interest rates on government liabilities; and absorption of nonperforming SOE debt in bank portfolios by the government.

These developments can be seen clearly in 1992, when the fiscal deficit increased again for all countries in the sample (in the case of Romania, the surplus turned to a significant deficit). However, it is critical to bear in mind that this increased deficit did not necessarily have a macroeconomic impact; many of these cleanup operations were primarily balance-sheet operations within the broader public sector. Nonetheless, the behavior of SOEs and commercial banks could not always be reformed overnight, and quite frequently SOEs and banks continued to behave on the assumption that there would be a bail-out. In addition, social benefits provided by the budget were sometimes more generous than what had previously been financed by SOEs. In these cases, a higher fiscal deficit did contribute to an overheating of the economy and higher inflationary pressures.

An additional development can be observed in the countries that are most advanced in the transition process, in particular Hungary. Despite relatively thin financial markets, Hungary succeeded in obtaining nonbank financing of the budget deficit, but in so doing graduated into a vicious spiral of increasing debt, further deficits, and higher interest rates. This process crowded out fledgling private sector activity.

The three non-European economies in transition are, in some respects, outliers as compared to their European counterparts. On the one hand, in Algeria the exchange rate depreciation substantially increased fiscal revenue from oil, resulting in a budget surplus in 1990–91 of over 5 percent of GDP. But this disappeared thereafter due to a sharp expansion in government expenditure. On the other hand, both the Lao P.D.R. and Mongolia started with much larger budget deficits (in excess of 10 percent of GDP in 1989) than the rest. The deficit narrowed in the Lao P.D.R., but remained more or less the same in Mongolia. Part of the relatively strong fiscal performance in the Lao P.D.R. can be explained by the large share of the agricultural sector, which, as in Poland, was predominantly in the nonstate sector, and permitted a relatively rapid supply response to reform measures.

"...governments face the daunting task of dealing with the immediate, difficult trade-off between the quantity and the quality of fiscal adjustment...."

Tax reform. The introduction of a market-based tax system in the countries covered by the study involved a two stage process. In the first stage, governments endeavored to correct the most serious structural distortions in the tax system and to raise revenue to reduce the budget deficit. They relied for the most part on the existing tax administration mechanisms. These first steps included reducing significantly the number of turnover tax rates to pave the way for the introduction of a value-added tax and excises, adopting an enterprise profit tax, introducing a progressive personal income tax with schedular features, unifying the payroll tax for social security, and converting a wide range of nontariff barriers into relatively low *ad valorem* import duties. In essence, the most important structural innovation was the introduction of parametric (fixed) tax rates, calculated on a more economically meaningful base, to replace the unpredictable and confiscatory revenue system that prevailed under central planning. Hungary stands out in this respect, as many of the first-stage structural reforms were introduced prior to 1990.

During the second stage, which currently is under way in most of the transition countries, the reform has been focused on completing the move toward a market-oriented tax system. This consists of a value-added tax, excise taxes, a broad-based progressive personal income tax, and a single-rate enterprise profit tax. To date, only Hungary has completed this second stage of tax reform. For these reform measures to be effective, a tax administration suitable for an economy dominated by the private sector and dependent on voluntary compliance by taxpayers has to be created. Indeed, tax administration proved to be the weak link in the reform process, despite an extensive program of technical assistance and institution-building.

All of the countries covered by the study experienced a deterioration in revenue performance during 1989–92. But this can be ascribed only partially to the effects of output contraction. Most of the rest of the decline in tax revenue reflects the poor state of tax administration, reduced SOE access to subsidies and bank credit that led many of them to run up tax arrears, and a shift toward private sector activity, which permitted many new firms to escape the tax net because of weak tax administration. This trend is particularly noticeable in the relatively advanced economies in transition, such as the former Czechoslovakia, Hungary, and Poland, but can also be seen in Romania. In the latter case, the early privatization of agriculture resulted in a considerable number of wage-earners leaving their jobs in SOEs—where their future was uncertain—to reclaim family farms. However, since the agricultural sector initially was granted tax preferences or simply escaped the income tax, this shift in the labor market contributed to the tax revenue loss. In addition, increased collection lags combined with continued high inflation explained part of the real revenue erosion in Bulgaria, Mongolia, and Romania.

Expenditure reform. Given the high initial level of government intervention in the economy, most adjustment programs aimed either explicitly or implicitly to downsize government operations in addition to reducing the fiscal imbalance. Hence, the burden of budget

deficit reduction was borne primarily by expenditure cuts. This outcome was consistent with these countries' intention to privatize the bulk of the productive structure. Apart from this quantitative goal, all of the countries also sought to reduce or eliminate the role of government in regulation (especially as regards price and wage controls), ownership, and of course, in resource allocation through central planning. These qualitative objectives had direct implications for the composition of expenditures.

While there was considerable scope for trimming expenditures—namely, price subsidies, prestige investment projects, and military outlays—at the outset of the transition, there have been mounting claims on public services in recent years. Ironically, after decades of socialist central planning, the magnitude of unsatisfied demand for public services—especially in infrastructure facilities, social protection, public safety, and environmental protection—remains far greater in these economies than in most market economies. In this regard a particular challenge consists of providing cost-effective social insurance schemes for old age, health care, and unemployment, as well as social assistance for low-income households.

Achieving expenditure targets implies some control over government outlays, yet an effective system of public expenditure monitoring has still to be established. Budgetary control as practiced under central planning was rather inadequate for a market-oriented economy. Furthermore, at the outset of the transition, most countries experienced a proliferation of extrabudgetary funds, and increased local government independence. Thus, to contain expenditures under fiscal stress, Bulgaria, Mongolia, and Poland had to rely on stopgap measures such as cash rationing of expenditures. Several countries in transition are now introducing market-based techniques of cash management and are intent on reversing the initial trend of fiscal decentralization.

Reforming the enterprise sector. In contrast to the relatively successful reduction or elimination of budget deficits in most of the countries at the outset of the adjustment, the state enterprise sector has represented an increasing challenge. Initially, the tight credit and tax-based incomes policies—introduced in all the European countries in the sample—applied to the SOEs were largely effective in moderating wage inflation. Increasingly, however, SOEs circumvented these restrictions on their operations by accumulating payment arrears to other enterprises and banks, and for government tax payments. Although present in all countries, this problem has been especially acute in Romania. A solution to the arrears problem—as well as the question of how to deal with the buildup of nonperforming loans on banks' balance sheets—is being sought through a combination of measures: bank recapitalization operations, debt restructuring, prudential regulations, and, more recently in the case of Hungary, through widespread implementation of bankruptcy legislation. (See "Dealing with the Bad Debt Problems in Transition Economies," by Sanjay Dhar and Marcelo Selowsky, *Finance and Development*, June 1994.) Further, the effectiveness of tax-based incomes policies is rather short-lived, and can dampen labor market flexibility. As a consequence, major efforts to speed up privatization and restructuring of SOEs, and substitute a conventional incomes policy for the tax-based incomes policy, are under way in several countries.

What have we learned?

The experience of countries included in the study provides a number of useful lessons in the fiscal area, especially for the states of the former USSR, where many of the same issues are now emerging.

Successful stabilization during the transformation to a market-oriented system requires a front-loaded fiscal adjustment aimed at eliminating or narrowing significantly the budget deficit. Besides the direct contribution to stabilization, such a policy can help cool inflation expectations in economies facing severe macroeconomic disequilibria. However, as the transition runs its course, the burden of adjustment increasingly falls on expenditure reduction at a time of mounting claims for unemployment compensation and other social benefits, and outlays associated with restructuring SOEs and the banking system. These competing forces generate tensions that can slow or even temporarily halt the reform effort.

To build and maintain broad-based support for reform, it is important to develop measures to shield the poor from the initial adverse effects of adjustment. In most economies in transition the existing social protection network needs to be overhauled and focused on those who are most in need of assistance.

Most extrabudgetary activities should be consolidated with the budget as part of an effort to enhance transparent and effective budgetary control. As a major exception, social insurance funds should operate separately; likewise, there may be scope for financing off-budget public services with user fees. Financing of social insurance and other services with earmarked payroll contributions and user fees represents an application of the benefit principle of taxation and a first step toward cost-effective provision of these services.

Phasing out quasi-fiscal activities conducted by SOEs and commercial banks must be viewed as an integral part of the fiscal adjustment effort in economies in transition. In the short run, these activities have to be curtailed mainly by a tax-based incomes policy plus limits on bank lending to SOEs, supported by regulations to prevent the emergence of interenterprise arrears. These steps need to be taken in tandem with the adoption of bankruptcy provisions, enterprise restructuring, and privatization. Such measures are indispensable for the imposition of a hard budget constraint on SOEs.

Further tasks

For countries that have nearly completed the initial stage of the transformation to a market system, several tasks remain. Beyond the initial task of taming inflation, it will be necessary to pay increasing attention to the medium-term implications of budget deficits for private investment and growth. Although difficult to document, there is a risk that productive capital formation might be crowded out, especially as widening fiscal imbalances are financed increasingly from nonbank sources. Further ahead, an area of additional concern is the prospect of the long-run sustainability of the public debt accumulated through successive budget deficits and bank recapitalization operations. The concerns with crowding out and with debt sustainability—already being experienced, for example, by Hungary—hinge, of course, on the outlook for domestic savings and growth, which, in turn, depends on correcting the fiscal imbalance. Clearly, continued deficits tend to result in rising public debt-to-GDP ratios that are reflected in higher interest rate risk premia and lower economic growth.

In the medium term, to pave the way for sustained growth, it is necessary to undertake or complete a number of unfinished tasks such as social security reform, stepped-up infrastructure investment, overhaul of local government finances, and completion of the removal—or explicit costing in the budget—of the quasi-fiscal activities of SOEs and the banking system. In sum, governments face the daunting task of dealing with the immediate, difficult trade-off between the quantity and the quality of fiscal adjustment, that is, between the need to contain the fiscal imbalance and the need to pursue structural reform. ■

Social Protection During Russia's Economic Transformation

SANJEEV GUPTA AND ROBERT HAGEMANN

RUSSIA'S social safety net has to be strengthened if economic reform is to be politically palatable. Contrary to some views, however, adequate social protection in Russia is attainable by improving the existing system.

The transition to a market economy in Russia has reduced most people's real incomes, especially the incomes of the poor. The sharp decline in output and the manifold increases in prices during the last three years have taken their heaviest toll on the more vulnerable segments of the population—the elderly or disabled, unemployed workers, workers receiving delayed or partial wages, and families with many children (Table 1). Cash income for many of these groups is below the estimated subsistence level.

As a result, poverty in Russia is increasing. In 1991, some 17 million persons, or 11.7 percent of the population, had incomes below the subsistence level; by 1992 that number had increased to 44 million, or about 30 percent of the population. Recent studies by Russia's statistical agency suggest that the gap between the highest and lowest income brackets has widened significantly in the past two years, while social indicators (e.g., health and education) have declined markedly.

Despite indications that poverty may have declined slightly in 1994, only broadly based, sustained growth can permanently reduce poverty in Russia over the longer term. In the meantime, the key issues are how to shield the vulnerable from the impact of price liberalization and reduced employment opportunities, and how to strengthen existing social protection schemes to protect their living standards. In fact, the IMF-supported economic program being pursued in Russia includes measures aimed at strengthening the existing system of social protection.

Table 1
Coming through the transition
Economic and social indicators

	1992	1993 estimate
Real GDP (percentage change)	-19.0	-13.0
Consumer price index (percentage change)	1,353.0	932.0
Employment and wages		
Average employment (in millions of persons)	72.3	71.5
Registered unemployment (in millions of persons)	0.6	0.7
Average nominal wage (thousands of rubles per month)	6.0	58.5
Average real wage (percentage change)	-38.0	1.0
Minimum wage/average wage (in percent)	11.9	11.3
Major cash benefits		
Average benefit/average wage (in percent)		
Pensions	31.3	36.3
Unemployment benefits	18.0	11.6
Child allowances	5.3	4.3
Number of beneficiaries/number of employed (in percent)		
Pensions	47.2	49.4
Unemployment benefits	0.2	1.0
Child allowances	62.2	62.6

Sources: Ministry of Finance of Russia, Pension Fund, Employment Fund, and Social Insurance Fund.

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The safety net

Russia has an elaborate system of primary social protection, which includes subsidies on some food and other consumption items (e.g., public transportation), pensions, newly established unemployment benefits, sickness and maternity benefits, child allowances, and social assistance programs (see box). Pensions and unemployment insurance are permanent social security instruments and can play important social protection roles during the transition period. Secondary instruments of social protection are social assistance programs that assist individuals who receive insufficient or no benefits from the primary programs.

These social protection schemes are financed and administered by a variety of extrabudgetary funds, as well as directly by the central and local governments (Table 2). In 1993, Russia spent some 8 percent of GDP on social protection, excluding outlays on education and health. Roughly two thirds of spending on social protection was for pensions, while most of the remainder was for the other social programs (see chart).

Inadequacies of the system

Russia's current system of social protection suffers from a number of shortcomings. The challenge is to make the existing system cost-effective while ensuring adequate protection for those who need it most. Some of the major shortcomings of the system include:

Unequal and low benefits. During Russia's economic transformation, only the real incomes of those considered to be most at risk can be shielded, and, within this group, the burden of adjustment has to be borne equitably. During recent years, pensioners have on average fared somewhat better than the unemployed. The low level of unemployment benefits is due partly to the fact that unemployment compensation is determined with a declining statutory replacement rate—which measures the relationship between unemployment benefits and a worker's last wage—and no price indexation. This factor, together with the social stigma attached to being unemployed, results in many unemployed not registering for benefits. Moreover, the cost of becoming unemployed is especially high because of the extensive provision of social benefits within enterprises. Because unattractive unemployment benefits create incentives for state-owned companies to hoard labor, the system clashes with reforms designed to promote economic restructuring and to improve economic efficiency.

About 30 percent of pensioners receive a minimum pension below the estimated minimum subsistence income. Hence, many of these pensioners (16 percent) try to make ends meet by continuing to work. However, a large proportion of pensioners with higher benefits also work. In many cases, these pensioners continue to work at the same job after reaching the statutory retirement age. In a tight fiscal situation, this practice has introduced an inequity in the social protection system—between those receiving below subsistence pensions and those with above minimum subsistence pensions and, in addition, earned income. Paradoxically, while some vulnerable groups receive inadequate protection, others may receive relatively

Social protection in Russia

Pensions. One out of every four Russians is a pensioner (35 million people). For many, pensions are the primary, and in many cases the sole, source of cash income. The ratio of the average pension to the average wage—the so-called replacement ratio—was 36 percent in 1993, an improvement over the mid-1992 ratio of about 31 percent. There are, however, roughly 10 million pensioners who receive a minimum or very low pension that is less than the estimated minimum subsistence income for pensioners.

Unemployment benefits. The number of registered unemployed in Russia since the beginning of the reform process has been relatively modest. There were some 1.2 million registered unemployed in May 1994—a registered unemployment rate of about 1.6 percent. Of these, only 1 million drew unemployment benefits, however, and another 3 million unemployed had either exhausted their unemployment benefits or had chosen not to register. Close to an estimated 8 million individuals were on short working days or partially paid or unpaid leave in the first quarter of 1994. Consequently, only about 9 percent of the total unemployed and underemployed received cash unemployment benefits. The average unemployment benefit in relation to the average wage was meager at about 12 percent in 1993—about one third of the average benefit received by pensioners—and substantially lower than the minimum subsistence income for a working person.

Other social-insurance type benefits. These include birth, maternity, and sickness benefits to meet various contingencies of short-term income loss of those who are employed.

Child allowances. A traditional means of providing financial assistance in Russia, as elsewhere in the former Soviet Union, is through child allowances. There are some 39 million children in Russia below the age of 18. Until end-1993, there were 14 types of child allowances, but these were consolidated into three allowances in 1994. Child allowance is linked to the minimum wage and varies with the age of the child. The amount of the average child allowance has been rather small—about 4 percent of the average wage in 1993. Federal and local budgets, together with the social insurance fund, share the cost of child allowances. Faced with the need to contain the fiscal deficit, and lacking a well-defined cost-sharing mechanism, state and local governments have tended to underfinance child allowances.

Social assistance programs. A number of social assistance programs, run by the Ministry of Social Protection in collaboration with local authorities, target the disadvantaged, including especially disabled persons. An extrabudgetary fund—Fund for Social Protection of the Population (FSPP)—is also engaged, among other things, in selling humanitarian aid received from abroad. Because of a lack of regular sources of revenue, however, the FSPP engages extensively in income-producing activities, ostensibly helpful to the poor, such as investment in the production of goods consumed heavily by the poor.

Food subsidies. In Russia, three food items—bread, milk, and meat—are subsidized, mostly at the local level. Local governments can regulate the prices of these commodities, and what they spend on subsidies depends in part on their financial position, and in part on the transfers they receive from the federal budget. As a result, the data most probably do not fully capture the amount spent on food subsidies, and do not include any implicit subsidies borne by producers because of price regulation.

generous benefits. For instance, the social insurance fund provides sickness benefits that are generous by international standards, and subsidizes workers' stays in health spas and resorts by covering their operational costs and providing discounted vouchers.

The average amount of child allowance is also too low to have an appreciable impact on the well-being of a poor family. There is evidence that many children are in fact not receiving the payment because of fiscal difficulties at both local and federal levels. If, as a result of tight fiscal conditions, the average benefit is set too low, inequities result, as less needy families continue to receive payments.

Fragmented benefit administration. The average benefit level has also been affected adversely by the fragmentation of administration between the local and federal governments. For instance, the central Employment Fund receives 10 percent of payroll tax receipts, and the other 90 percent is retained at the local level. The center's share is hardly sufficient to meet the needs of localities whose level of unemployment increases and, hence, whose revenue base contracts. At present, there are no intergovernmental mechanisms for equalizing funding among different local governments.

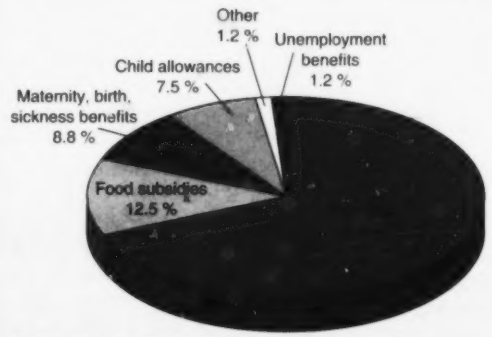
Poor coverage. Currently, those unemployed who are not registered receive hardly any income support, as reflected in exceedingly low participation rates of retraining and public works programs. Thus, a large number of unemployed are not covered by the existing system of social protection, although some of them work in the informal sector and earn enough for a minimum standard of living.

At the local level, various programs are geared to serving the disabled, and these need to be sustained during the difficult period of transition. However, few mechanisms, if any, exist at the local level to reduce the gap between family income and the minimum necessary to attain an adequate standard of living. Such mechanisms are necessary to track the working poor and those individuals who do not receive enough from the primary social protection network.

Weak financial base. Statutory payroll tax rates in Russia are relatively high. However, the "effective rates"—the rates actually paid by the working population—are lower than the statutory rates by 20–35 percent, reflecting the nonpayment and/or underpayment of taxes by businesses, legal exemptions, and, more recently, delays in receipt of payments or arrears. Low effective rates also reflect the lower rates applied to some sectors (agriculture) and enterprises (those employing the handicapped), and the self-employed, designed ostensibly to reflect differential risks. Lower than expected revenue collection, in turn, has limited the ability to close the gap between minimum benefits and minimum subsistence levels.

Wasteful expenditures. Two of the extrabudgetary funds—Employment Fund and Fund for Social Protection of the Population—provide wage and other subsidies to enterprises with the principal objective of maintaining employment. There seems little rationale for providing subsidies for employment that are also financed by workers' social insurance contributions that are meant to cover unemployment.

Spending on social protection in Russia, 1993



Sources: Ministry of Finance, Pension Fund, Employment Fund, and Social Insurance Fund.

Table 2
Administering social protection in Russia

Program	Agency	Funding source
Pensions	Pension Fund (PF)	Payroll tax of 29 percent for most workers
Food subsidies	Local governments	Local budget, central government transfers
Unemployment benefits	Employment Fund (EF)	Payroll tax of 2 percent for most workers
Child allowances	Local governments, enterprises	Central and local government budgets and SIF
Birth, maternity, sickness benefits	Social Insurance Fund (SIF)	Payroll tax of 5.4 percent for most workers
Social assistance programs	Local and central governments	Local and central government budgets; and an extrabudgetary fund

Making the system effective

The social safety net in Russia can and should be made more effective, and this can be done within the tight fiscal constraints present during the transition to a market economy. In the short term, the existing social protection instruments can be adapted to establish a more effective social safety net. During the transition, however, Russia faces potential conflicts between short-term and long-term reform agendas. Over time, it is critical that social insurance schemes—especially pensions and unemployment compensation—be made as effective as possible, based on sound economic and actuarial principles.

Some basic principles. In the short term, a number of principles that recognize the financial and institutional constraints in Russia today should underpin more effective safety nets.

- Eligibility requirements should aim to provide effective protection to potentially all members of vulnerable groups; this requires careful targeting.
- Benefits should be set at levels that balance social adequacy with available resources.
- Protection schemes should recognize short-run administrative constraints.
- The design of social benefits should be compatible with fostering the development of the private sector and competition.

One of the critical principles for an effective safety net is that minimum benefits should at least equal the minimum subsistence income, and be fully protected against inflation. The minimum pension remains below the minimum subsistence income for pensioners, and should be raised. The decision in Russia in late 1993 to switch from full price indexation of all pension benefits to a flat, indexed payment

to all pensioners reflects the need to at least protect the purchasing power of less well-off retirees to a greater extent than their counterparts with more income.

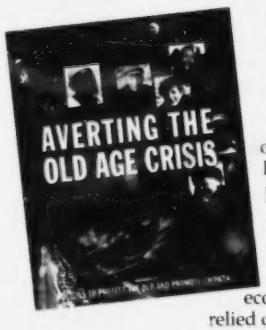
For the system of unemployment insurance to operate as a catalyst for the macroeconomic and structural adjustment that is needed in Russia, however, the average benefit must clearly be increased from levels observed to date. A higher average benefit could induce more unemployed to register and assist the process of industrial restructuring. Beyond unemployment compensation, and especially for those workers who have exhausted allowed benefits, additional resources for retraining and public works are needed to complement other forms of assistance.

Improved targeting of child allowances, if direct identification of larger poor families is not possible, could be achieved by limiting allowances to second and additional children. This will also save resources that could be used to finance other benefits or to increase the value of child allowances. Further improvements in the minimum and, in some cases, average benefits currently provided in the Russian social protection system can be financed without recourse to new forms of financing.

This will require a number of steps to both enhance revenue and make expenditures more cost-effective. About one half of additional resources can be found by rationalizing the benefits structure. For example, pensions for working pensioners receiving more than the minimum pension could be reduced. The retirement age for both women and men—low by international standards at 55 and 60, respectively—could be raised gradually. The cost of sickness benefits could be borne by employers for the first few days, and subsidies for vouchers for sanatoria could be eliminated. Wasteful practices, such as wage subsidies paid by the Employment Fund to enterprises, could be eliminated.

On the revenue side, compliance with the payroll tax could be strengthened through more widespread and frequent audits and by levying a positive real interest rate on overdue contribution payments. Also, payroll tax exemptions could be reduced or totally eliminated. Both the Pension Fund and the Employment Fund could generate additional resources by putting their surpluses in accounts that pay market interest rates. The resulting strengthened social safety net can be expected to play an extremely catalytic role in accelerating the transition to a market economy. ■

THE FIRST COMPREHENSIVE AND GLOBAL EXAMINATION OF OLD AGE SECURITY



AVERTING THE OLD AGE CRISIS: POLICIES TO PROTECT THE OLD *AND* PROMOTE GROWTH

Addresses how to ensure financial security for the old and the best ways of paying for such security. Identifies the functions of old age financial security programs—redistribution, saving, and insurance. Evaluates the policy options for meeting these functions by measuring their impact on the aged and on the economy.

Suggests that financial security for the old and economic growth would be best served if governments relied on a mix of

- Publicly managed systems with mandatory participation and the limited goal of reducing poverty among the old
- Privately managed mandatory savings systems, and
- Voluntary savings systems.

These three systems would ensure against the many risks of old age. The report concludes that a combination of different income security policies is more effective than any single approach and that all countries should begin planning for their aging populations now.

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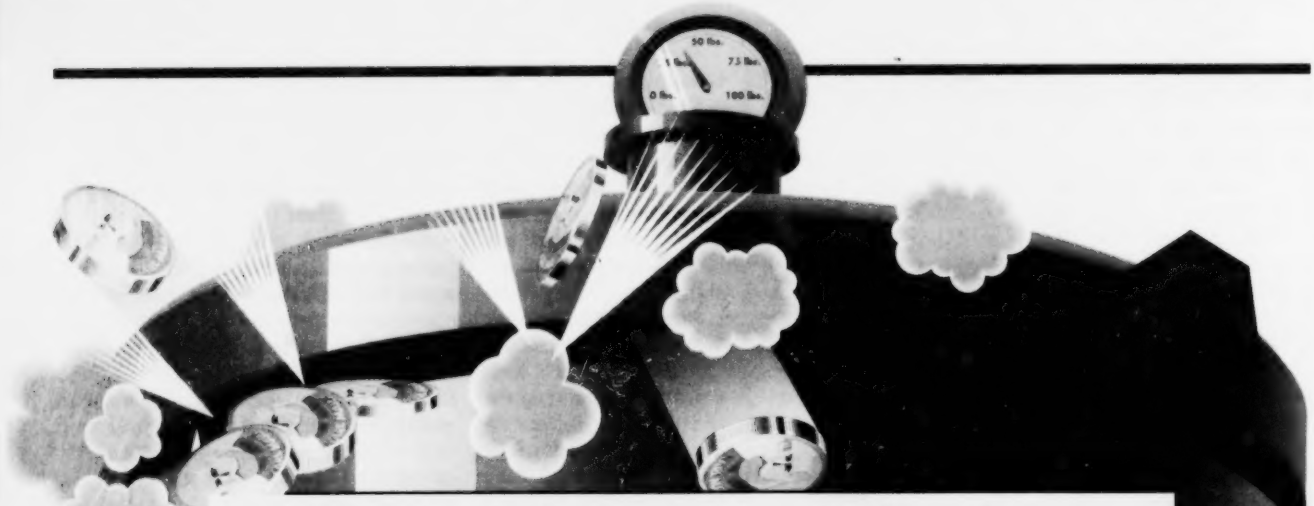

Should Russia Adopt a New Incomes Policy?

MICHAEL MARRESE

SOCIALLY agreed controls on wages would be one way of dampening inflation in Russia—thereby enhancing the chances for economic prosperity. But experience in many countries shows that incomes policies are extremely difficult to enforce, raising serious questions about whether they are the answer for Russia.

Since the breakup of the USSR, rampant inflation has been a major problem in Russia, with monthly increases in consumer prices of 30 percent during 1992, 21 percent during 1993, and 10 percent during the first half of 1994. Wages—namely, "statistically recorded earnings due," which were higher than the wages people actually received because of the substantial lags in wage payments—have tended to move in line with most prices (Chart 1), the one significant exception being the exchange rate. For example, the real national average wage fell only 10 percent from June 1992—when it equalled its 1987 level, the last year that consumer prices were stable—to June 1994 (Chart 2), while over the same period, the national average wage in dollar terms increased 170 percent.

While average inflation during much of 1994 was significantly lower in Russia than in previous years, signs of macroeconomic instability have remained prominent (e.g., large budget deficits, the sharp growth during late 1993 and 1994 in wage, inter-enterprise, and tax arrears, and the unsettling swings in the exchange rate). Hence, there remains a deep concern that macroeconomic instability—including difficult to anticipate price and wage increases—could undercut much of Russia's economic transformation by promoting capital flight and discouraging inflows of foreign direct investment.

Besides trying to implement sound financial policies, countries have often tried to control inflation, or even break its momentum when there is hyperinflation, through the adoption of incomes

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policies—as part of what are known as "heterodox" stabilization programs. Incomes policies usually involve coordinated wage setting, or penalties designed to reflect the negative spillover effects of price and wage increases, or even price and wage freezes coupled with the exchange rate acting as the main nominal anchor. For typical market economies, incomes policies may offer a way of improving the short-term trade-off between inflation and unemployment. These policies may also be appropriate for state-controlled firms whenever the state, as owner, fails to enforce hard budget constraints and to act as a profit maximizer, thus giving managers and employees the opportunity for higher wages and less investment than would occur under more effective ownership. But the record of incomes policies for both industrial and developing countries is quite mixed, largely because of problems with enforcement, distortions caused by rigidities in relative wages, and the time and resources "wasted" trying to circumvent incomes policies.

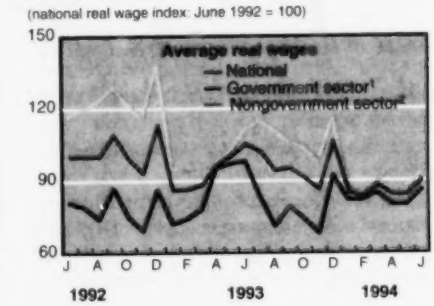
In recent years, Russia has experimented with a rather weak incomes policy, which, not surprisingly, has proven to be quite ineffective. The policy could be strengthened by temporarily setting penalty tax rates on excess wages of state enterprises prohibitively high, by utilizing tripartite bargaining, by allowing for the revision of excess wage norms in response to greater than anticipated inflation, and by focusing directly on managerial compensation packages. However, practical considerations suggest that the chances of success are slim, meaning that Russia should first exhaust other alternatives before adopting a tough incomes policy.

Chart 1

Russia's wages and prices move together

Chart 2

Russia's real wage roller coaster ride



Sources: Goskomstat of Russia and IMF staff calculations.

[1]The government sector is comprised of the following five sectors: housing, communal services, and nonproductive household services; health care, physical training, and social security; public education; science and science services; and government employees, public organizations staff, etc.

[2]The average nongovernment sector wage is derived from the following equation: (national average nominal wage) = (national average government sector wage)*w1 + (national average nongovernment sector wage)*w2, where wi = (employment in ith sector)/(total employment), for i = 1,2.

Russia's record so far

Since Russia's rebirth as an independent country, it has struggled, largely unsuccessfully, to achieve macroeconomic stability—particularly on the inflation front. Even so, the government has not introduced a tax-based incomes policy (TIP) with prohibitive penalties on excess wages. Rather, during 1992, it relied on a weaker policy, which eliminated the deductibility from profits of the excess wage bill, defined as that part of the wage bill in excess of "the number of employees multiplied by four times the minimum wage." Accordingly, the excess wage bill was effectively taxed at the enterprise profit tax rate of 32 percent. Then in 1993, the excess wage bill was taxed progressively: any amount up to "the number of employees multiplied by four times the minimum wage" was treated as costs and not taxed; any amount of the wage bill ranging from "four to eight times the minimum wage multiplied by the number of employees" was treated as profits and taxed at 32 percent; and any amount above "the number of employees multiplied by eight times the minimum wage" was taxed at 50 percent. In addition, regional coefficients widened the wage-tax brackets for relatively high-cost regions. For 1994, the maximum deductible wage cost was raised from four times to six times the minimum wage, with agricultural entities exempted.

The high level of tax revenue generated by the excess wage tax—roughly 3 percent of GDP in 1993, or one quarter of all profit tax collected—and steep wage inflation suggest that this tax has not been effective in restraining overall wage growth. The reasons are many.

- The 1987 Law on State Enterprises allowed enterprises to retain a higher share of internally generated funds and to channel more "retained earnings" to wages. Shortly thereafter, upper limits on managers' salaries were set equal to a multiple of an enterprise's average wage rather than being based on enterprise performance (the earlier practice). Thus, managers had little incentive to oppose demands for higher wages.
- Managers ignored the tax because they believed that soft budget constraints would continue to prevail and that providing jobs and relatively high wages were either the "right things to do" or would lead to substantial side payments.
- The government has not taken its own excess wage guidelines seriously, as government wages (housing, health care, public education, science, defense, and public sector employees services) have grown sharply since January 1992 compared to nongovernment wages and the minimum wage. For instance, the ratio of the government wage to the minimum wage rose from 4.2 in January 1992 to 6.8 in January 1993 and to 13.5 in June 1994.
- Highly subsidized sectors, such as coal mining, have been able to grant high wage increases in the absence of hard budget constraints.
- Enterprises have circumvented wage restrictions through the creative use of fringe benefits. For example, an automobile manufacturer reportedly bartered about 30 percent of its annual output for inputs such as glass and tires. The suppliers of these inputs then sold the cars to their workers at 10 percent of the market price, thus avoiding the penalty for excess wages and most of the value-added tax.
- The government has not taken a firm anti-inflationary position with trade unions that represent entities dependent on state subsidies.

How an incomes policy works

Should Russia's incomes policy be strengthened? First, it helps to take a look at the record so far in formerly planned economies. In these economies, incomes policies most often have limited wage growth among state firms that generate high net income per employee (via the use of monopoly power, or by consuming their own capital, or by being highly competitive). Since competitive firms are highly

sought after, targeting state firms is consistent with the idea that state firms are not highly competitive and the unregulated private sector will be the source of growth. Yet since incomes policies have been applied mostly to state enterprises, they also have been developed as temporary measures because the private sector has been growing rapidly, and the state is expected to become a more effective owner.

How have these policies worked? Typically, policymakers have selected one of three targets—job-specific wage rates, an enterprise's average wage, or an enterprise's total wage bill—and have restricted the increase in the target variable by setting upper growth limits and penalizing (usually through taxation) any increment beyond the set limits. The least used in formerly planned economies has been the regulation of a firm's average wage, because it encourages state firms to hire superfluous low-paid employees simply to increase the average wage of the remaining employees. Regulation of the lower and upper bounds of job-specific wages has been applied to government employees. The most popular target has been the wage bill because its regulation gives managers an extra reason to shed workers who are paid too much relative to their productivity, and it is ease to apply and enforce. Yet wage bill regulation may create an incentive to shift the composition of the labor force toward lower paid, less skilled workers.

Determining whether an incomes policy has succeeded is no easy task; indeed, it can be judged only in the context of accompanying policy measures. For instance, an incomes policy *ex post* may seem to have been redundant whenever a wage increase has been significantly less than the maximum allowable norm, which could happen in the context of prudent fiscal and monetary policies, and when structural changes that harden the budget constraints of state enterprises have been implemented. However, the presence of an incomes policy *ex ante* may, if credible, affect expectations and reduce pressure on the authorities to pursue expansionary fiscal and monetary policies, and thus may be essential. Also, a well-designed incomes policy may be judged to have failed because nominal wage targets exceeded the norm implied by the incomes policy, yet it would have achieved its objectives had it been supported by sound fiscal and monetary measures.

Lessons for Russia

Since World War II, numerous countries, including the former USSR, have experimented with various approaches to incomes policies. But the record is decidedly mixed, and when the policies have worked, very specific elements were in place—elements that for the most part are unlikely to exist in the Russia of today.

(1) Collective wage bargaining. First, consider an incomes policy based on collective bargaining, with national coordination of the process, as was used successfully in Austria, Norway, and Sweden during the post-World War II era. The success was connected to: institutions accepted as valid representatives of labor, management, and government; a consensus that labor's prevailing share of national income was sustainable; each party's understanding of how a wage-price spiral could be generated; and agreement that such a spiral must be avoided. For Russia, however, such an approach looks unsuitable. The government has represented both management and itself, and hence has had no independent role in wage negotiations. Moreover, unified national labor unions do not exist in Russia and existing trade unions have doubted the government's ability to dampen inflation.

"...any incomes policy for Russia should be temporary, apply only to state enterprises, and include prohibitive penalty tax rates."

(2) Decentralized collective bargaining. Next, consider a policy of decentralized collective bargaining with strong trade unions such as existed in the United Kingdom during the 1950s and early 1980s. The acrimonious strikes and deteriorating labor-management relations of this period were not encouraging. In the United States, during the 1960s and 1970s, similar conclusions could be drawn even though the strikes were less contentious. In some areas of the Russian economy (energy and transportation), this has occurred since the late 1980s, and has not led to more cooperation between trade unions and the government.

(3) Heterodox stabilization programs. In high inflation situations (e.g., Argentina in 1967 and 1985, Brazil in 1964 and 1986, Israel in 1986, and Mexico in 1986–87), price and wage controls—often actual price and wage freezes—coupled with making the exchange rate the main nominal anchor sometimes combined successfully to break an inflationary persistence that had become a stumbling block to stabilization. (Such persistence may have been due to a high degree of indexation in the economy or a strongly held belief that the government's policy statements lacked credibility.) Moreover, in all successful cases, the authorities implemented sound fiscal policies. In Russia, however, blanket price and wage controls (much less actual price and wage freezes) seem out of place because the economy is still a long way from attaining reasonably correct relative prices.

(4) Wage indexation. Then consider wage indexation in which upper bounds on job-specific wage schedules move with inflation according to a coefficient determined during tripartite bargaining. This policy, used in Western Europe mostly to set wage schedules for government employees, became associated with prolonged wage-price spirals due to the high level of indexation and because government employees lowered their opposition to inflationary policies. Moreover, this type of incomes policy seems ill-suited for Russia where relative wages have not reached stable positions.

(5) Tax-based incomes policy (TIP). No doubt the most promising approach for Russia is a TIP, which involves taxing, at prohibitive rates, wages that exceed some norm, itself a function of an enterprise's wage bill or average wage and either past or projected inflation. It also includes either a commitment to reopen wage negotiations whenever inflation exceeds forecast levels by a pre-specified amount, or an agreement on the maximum allowable decline in the real wage.

In Poland, a TIP on the wage bill was applied to both the state and private sectors on January 1, 1990. The norm moved with consumer price increases, the coefficient varying between 0.2 and 1.0 during 1990. If an enterprise did not take advantage of the margin under the norm during the early part of the year, it had the option of catching up later. For the first six months of 1990, wage growth was under the norm, quite possibly because enterprises had agreed to wage increases relative to forecast inflation, while actual inflation was much higher. Enterprises more than caught up in the second half of 1990, reaching wage levels slightly above the norm. Nevertheless, the average real wage in 1990 fell by 31 percent year-on-year, close to the government's target of 30 percent.

The Polish Government made three adjustments at the end of 1990: the TIP would no longer apply to private firms; the excess wage tax would apply to only one half of the 1990

overruns; and 50 percent (as compared to the original allowance of zero percent) of any 1990 overrun would be added to that enterprise's starting base for 1991. In addition, the tax base was switched from the wage bill to the average wage in order to moderate the incentive to shed labor. The same basic pattern repeated itself in 1991—only about one third of the excess wage tax was paid and then mainly by heavily subsidized state enterprises. Once again at the end of 1991, 50 percent of any overrun was added to the starting base for 1992. Moreover, enterprises quickly became quite adept at avoiding TIP penalties by shifting compensation from wages to benefits (subsidies for kindergartens, clinics, sports facilities, and so forth), by running up wage tax arrears, or by granting employees loans at below market interest rates. So even though the system appeared to be restrictive in 1992 with the coefficient remaining at 0.6, the policy was not restrictive in practice.

On the plus side, Poland's incomes policy may have dampened pressure for loose financial policies in 1990 and saved the government from innumerable negotiations aimed at containing state-sector wages. Rapid growth in overall unemployment, along with employment opportunities in the private sector, also helped to constrain wage demands in the state sector.

In Romania, the government introduced a combination of upper limits to some job-specific wages and taxes on above-norm growth of the wage bill of state enterprises in 1991. This scheme probably contributed to the 14 percent decline during 1991 in the average real wage—substantial, but considerably less than the 25–30 percent fall initially envisioned—and to the shedding of a great deal of labor as firms sought to protect the wages of remaining employees. It is likely that the massive increase in unemployment during 1991 also helped to restrain wage growth. In 1992, the norm continued to be indexed (with a 50 percent coefficient) to inflation, but the wage bill was adjusted upward at the beginning of January, May, or September, whenever representatives of labor and government determined that the inflation of the past four months exceeded expectations.

In Bulgaria, the government adopted a TIP in July 1991 that included quarterly opportunities to readjust both wage bill ceilings and the minimum wage, whenever the increase in the agreed upon price index exceeded its forecasted level by more than 10 percent. The wage bill ceilings, determined during tripartite negotiations, were set to achieve a decline in the state sector's average real wage consistent with macro stabilization and structural transformation. In 1991, the average real wage in the state sector fell by 42 percent (more than the 35 percent originally targeted), and unemployment rose from 1.6 percent to 10.2 percent. This trend continued during the first quarter of 1992, with the average real wage falling faster than targeted and unemployment growing rapidly. Thus, real wage growth in Bulgaria may have been limited more by high unemployment and a hardening of enterprise budget constraints than by wage ceilings.

In the former Czech and Slovak Federal Republic, the government adopted a two-stage TIP and created the tripartite Council for Economic and Social Agreement in 1991. During the first stage (January–February 1991), the average wage level of state enterprises could have increased without penalty by a cumulative 5 percent (6 percent for government entities) above the level of December 1990. If inflation for the first two months exceeded 25 percent (which it did), the wage ceiling was to be adjusted so that the average real wage in March would have fallen by not more than 12 percent below the December level. For the rest of the year, the indexation was designed in a manner consistent with a maximum 10 percent decline in the real wage relative to December 1990 for those enterprises that could afford to increase nominal wages. In practice, the decline in the real wage was much greater than anticipated and the prohibitive tax rates never were applied because state enterprises faced hard budget constraints. In fact, the average wage levels of most state firms rose less than the permissible increase, which during 1991 had been reduced by the tripartite council.

In Hungary in 1990, the government, disappointed with earlier TIPs, rejected prohibitive penalties on excess wages. Instead, it introduced the nondeductibility from taxable profit of that portion of the wage bill in excess of a norm based on projected price increases. Tripartite bargaining was employed and negotiations would reopen if inflation exceeded forecast inflation (which never happened). Declines in real wages were targeted in 1990 and 1991, but the parameters were not set tightly enough to have much impact. Incomes policy was abandoned at the beginning of 1992 in the belief that state enterprises already faced hard budget constraints.

In the former USSR, the government reacted to the sharp jump in wages relative to productivity in 1988 by experimenting unsuccessfully with several types of incomes policies. In 1989, it tried to hold the growth of a firm's wage fund to no more than that firm's growth of measured labor productivity. But during the first three quarters of 1989, wages rose much faster than productivity, prompting the authorities to implement a TIP with prohibitive tax rates. However, the TIP was eventually rendered ineffective by the sheer pervasiveness of the exemptions. In the end, these incomes policies fell prey to soft budget constraints.

What Russia might consider

What does all this imply for Russia? If policymakers choose to adopt a tough incomes policy, then their success will depend on fiscal and monetary measures, the hardness of enterprise budget constraints, the sanctions against noncompliance, and the social safety net. In theory, if a credible tax-based incomes policy with prohibitive penalties for excess wages were in place, the authorities might find it easier to enforce suitably tight monetary and fiscal policy (and vice versa).

In this vein, any incomes policy for Russia should be temporary, apply only to state enterprises, and include prohibitive penalty tax rates. In addition, regulation of the wage bill would be preferable to average wage regulation because the state sector has yet to shed surplus labor. Tripartite bargaining over the TIP should focus on the maximum allowable decline in the real wage in those state enterprises that have relatively high net income and on the parameters of the social safety net. Revision of excess wage norms whenever inflation exceeds forecast inflation by a sufficient amount should also be part of any TIP in order to protect labor from unsound fiscal and monetary policies. Finally, given soft budget constraints, managers who "allow" excess wage payments should have their own compensation packages reduced accordingly.

That being said, implementing an incomes policy in Russia may be difficult in practice. First, most Russian political leaders see incomes policy as an outdated remnant of the pre-reform period, and as a policy that has proven difficult to enforce. Second, corporatization and privatization have made significant strides in Russia, making it difficult to distinguish state enterprises from other enterprises. Third, if hard budget constraints are not in place, Russian enterprises will use time and resources to circumvent any incomes policy; if they are in place, an incomes policy might turn out to have been redundant. Fourth, the fairness of an incomes policy is more difficult to justify in late 1994 than it was several years ago because average wage differentials across branches have widened for reasons unrelated to productivity differentials. Thus, the idea of strengthening an incomes policy in Russia at this time should be viewed with considerable caution. ■

For more details, see the author's "An Incomes Policy for Russia?" Economic Systems, Vol. 18, No. 1, March 1994.

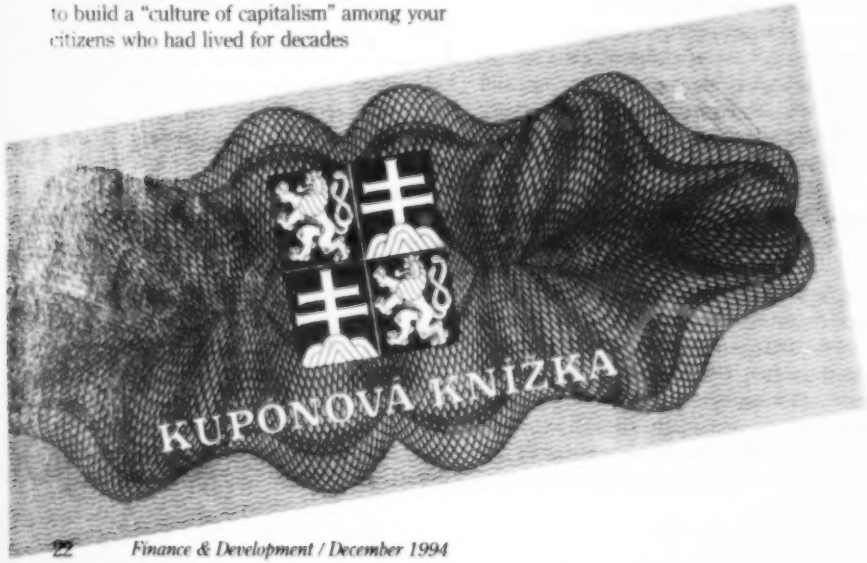
Mass Privatization in the Czech and Slovak Republics

NEMAT SHAFIK

THE INNOVATIVE mass privatization program succeeded in transferring ownership quickly and in a way that insured that everyone benefited directly from the reform process.

What would you do if you had to privatize over 7,000 medium- and large-scale enterprises quickly, but you had no idea what they might be worth? Moreover, what if you were in a formerly communist country where household savings rates were low, less than 1 percent of production was generated by the private sector, and there were no significant domestic capitalists who could buy such enterprises? Finally, what if simply auctioning assets would result in foreigners acquiring firms cheaply, thereby thwarting your efforts to build a "culture of capitalism" among your citizens who had lived for decades under central planning? This is the policy dilemma that the Czechs and Slovaks faced in the immediate aftermath of the 1989 "Velvet Revolution," which inaugurated the transition to democratic rule. (The analysis throughout refers to the federation that existed between the Czech and Slovak Republics until end-1992, unless otherwise stated.)

The solution they came up with was an extremely innovative and controversial one. In effect, they created a new method of privatization: mass privatization. It overcame the absence of domestic savings by giving away shares to the public, and it overcame the problem of how to value enterprises' assets—one of the biggest stumbling blocks to privatization in transition economies—through a system of sequential auctions. Although it is too early to judge whether the scheme enhanced the productivity of enterprises, it is clear that the scheme met its basic objectives, without undue costs, and demonstrated the usefulness of sequential auctions for generating information about enterprises' true market values.



How to privatize?

The former Czechoslovakia started the transition to a market economy as one of the most extreme cases of a centrally planned economy, with about 98 percent of property in state hands as recently as 1989. There were about 7,000 medium- and large-scale enterprises and about 25,000–30,000 small-scale enterprises in the state sector. Almost by necessity, the government adopted a multitrack approach that relied on a variety of privatization methods, including: (1) restitution to original owners; (2) small-scale privatization through public auctions; (3) transfer of state property to municipalities; (4) transformation of cooperatives; and (5) privatization of medium- and large-scale enterprises through direct sales, public tenders, joint ventures, and the mass privatization scheme.

Government officials generally stuck with conventional methods of privatization in cases where these methods would result in a rapid transfer of ownership. But for the vast majority of medium- and large-scale firms another approach was needed, as conventional methods would have resulted in long delays and generated fears that public assets would be sold cheaply to foreigners or to a few rich nationals to the detriment of other citizens. Thus, policymakers opted for a mass privatization program for almost three quarters of the medium- and large-scale enterprises undergoing privatization at the start of the reform program.

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et akcií kupóny	Základní jmění (v tis. Kčs)	Čist. obch. jmění (v tis. Kčs)	Cizí pasiva celk. (v tis. Kčs)	Výkony	89	Bilanční zisk	89	Bankovní úvěry	89	Prům.	89
				(v tis. Kčs)	90	(v tis. Kčs)	90	(v tis. Kčs)	90	počet	90
					91		91		91	prac.	91
45 059	46 453	51 469	18 160								
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				136 383		42 330				548	DO
				181 952		50 157				526	OE
										490	
				14 955		-4 896					
				20 790		-1 815		297		183	PPT
				45 936		12 241		135		181	DOC
										157	ZPR

The enterprises in the "first wave" consisted of 1,491 firms, for a total book value of $10.6 billion (a "second wave" is going on in each Republic, albeit with different approaches after the break-up of the federation). The sectoral distribution mirrored the entire economy, with the largest number in the engineering and building and civil engineering sectors, followed by food processing, design, agriculture, and domestic trade. The average labor force was 850 workers, with a minimum of 6 workers and a maximum of 34,231. As other privatization methods, such as direct sales, grow in importance, the proportion of total assets privatized through the coupon scheme is likely to diminish to about one third of total book value.

Distributing coupons

The program commenced with the government publishing the list of enterprises to be privatized as well as detailed information about each firm—including book value, financial performance, output, employment levels, other shareholders (if any), and debts—to enable citizens to make informed choices. The government did not attempt to restructure enterprises prior to privatization, but instead focused on rapid preparation of enterprises for sale to private owners who would be best placed to restructure the firms. This approach was consistent with international experience that efforts at government-led restructuring are rarely worthwhile—the government's expenditures on restructuring tend not to be recouped when the firm is eventually sold.

All citizens over the age of 18 were entitled to "coupons" that allowed them to bid for shares in enterprises to be privatized. Over 80 percent of eligible citizens (equivalent to 8.5 million people) registered for coupons, paying a nominal fee of about $35 that covered all the administrative costs of running the scheme. In exchange, citizens received a coupon of about $1,250 in book value terms (reflecting the total book value of enterprises to be sold in the first wave divided by the number of people who purchased coupons). Of those citizens who participated, almost three quarters gave their coupons to one of the 429 private investment funds that had emerged independently to participate in the privatization program. These funds, which operate like mutual funds, played a crucial role in "market-making" because they had done considerable homework on the value of firms (see box). Since citizens had the option of turning over their coupons to the investment funds, they were able to self-select into two groups: informed and uninformed bidders. The uninformed bidders tended to give their coupons to an investment fund to manage, thereby boosting the proportion of information relative to "noise" in the market.

There were five bidding rounds. Initially, all shares were offered for the same price, but prices quickly diverged as the market responded to changes in demand—by the third round the spread between the highest and lowest price shares was 776-fold. By the final rounds, there was evidence that equilibrium prices had emerged—93 percent of shares on offer had been sold and 99 percent of the coupons distributed had been used.

How the auctions fared

An assessment depends crucially on whether one believes that "ownership matters." Judged by the government's own objective—transforming ownership through a fast and fair process—the scheme was successful. The fairly narrow objective reflected the view that ownership transformation alone was sufficient to achieve productivity gains in enterprises. While there is growing evidence that this transformation does result in improved performance, virtually all the evidence comes from market economies where privatization was part of an incremental, rather than a fundamental, effort. Thus, any economic assessment for a transition economy must also consider the consequences for corporate governance—whether the diffuse ownership that emerges reduces the likelihood that shareholders will take an active role in restructuring and overseeing the enterprise.

Speed. On this ground, the scheme was successful. The entire cycle of preparation, public information, and bidding for 1,491 enterprises took 14 months—an average of over three medium- and large-scale enterprises privatized per day. The economic gains from such speed are that there is less scope for assets to deteriorate when public enterprises remain in "ownership limbo" and a greater likelihood of rapid restructuring.

Equity. Equity was achieved by giving all citizens equal opportunities to obtain shares through a transparent process. There was no systematic bias in share allocations in favor of "insiders" (either management or workers), in contrast to subsequent mass privatization schemes in other transition economies (such as Russia and Poland). Even so, some equity issues did arise. Firms were required to proceed with privatization, regardless of declared insolvency, to avoid management using financial distress as an excuse for avoiding privatization. In some cases, these insolvent firms were very large or politically important and sometimes sold for high prices, reflecting expectations of a government bailout. However, any such bailout would have resulted in either windfalls to existing shareholders or to "renationalization" of the enterprises.

Corporate governance. The average firm emerged with about half its shares owned by investment funds (averaging three major funds per firm) and half owned by individual citizens. Thus, the investment funds can be expected to play a key role in enterprise restructuring, with the secondary market serving as an important way for them to consolidate their holdings (although they are restricted to owning no more than 20 percent of the shares in any enterprise). Will this structure of ownership help? On the plus side, anecdotal evidence of funds taking an active role in the supervision and control of enterprise managers and in the replacement of nonperforming managers in some enterprises is encouraging. But the funds will also be under pressure to distribute dividends, which may result in decisions inconsistent with long-term restructuring. Eventually, there is likely to be a differentiation across the spectrum between

Learning through bidding

Before the first round of bidding in the mass privatization program, there were two types of information available to bidders: (1) public information in the newspaper about enterprises' characteristics and past performance, and (2) private information that individuals and funds had about enterprises' prospects. Econometric analysis of the determinants of prices in the bidding rounds reveals that the former clearly mattered, especially in the early rounds when private information had not yet been revealed. Firms that sold for higher prices tended to be characterized by high profits, strategic investors (i.e., investors taking significant shareholding stakes), and small and highly productive labor forces. In one famous case, a typographical error resulted in an extra zero being added to the profits of a hotel being offered. At the end of the first round, demand for shares in the hotel were about 400 times the supply of shares—implying that people did rely on published information to guide their bids.

However, this published information could never explain more than 29 percent of the variation in firms' ultimate equilibrium share price. Rather, information revealed through the bidding process (such as a share's price in the previous round or the deviation of a share's price from the average in a particular round) held the key to eventual equilibrium prices. This "market information," reflecting forward-looking assessments, could explain 85 percent of the variation in prices by the final rounds.

Share prices increasingly behaved like a "random walk"—implying that past prices were the best predictor of future prices—which is consistent with expectations about how an efficient asset market would function. There is also evidence that citizens' bids tended to be correlated with bids by investment funds in earlier rounds, implying that citizens recognized and used the superior information possessed by the funds.

Arguably, under all mass privatization schemes, effective "secondary markets" for share trading will improve the initial valuation of enterprises' shares and send important signals about corporate governance. But the experience in several transition economies indicates that secondary markets sometimes take a long time to become active, often because information about firms is not available and few market participants want to trade in ignorance. Thus, mass privatization programs that use information effectively are likely to have a head start on establishing more efficient asset markets, encouraging better corporate governance, and creating more productive private firms.

funds wanting to operate like passive mutual funds, with small stakes in a diversified portfolio, and funds that will operate like venture capitalists, taking large stakes and activist roles in management.

Lessons learned

The mass privatization approach has now been copied and adapted in other transition economies—such schemes have taken place, are underway, or are under preparation in Bulgaria, Kazakhstan, Lithuania, Mongolia, Poland, Romania, and Russia. Each program reflects the objectives and constraints faced in each country. In a large country like Russia it was not possible to have simultaneous, nationwide bidding rounds, so auctions were held throughout the year at the local level. In Lithuania, citizens were able to use coupons to buy public housing in which they resided. In Poland, where the government worries more about corporate governance, bidding will rely more heavily on investment funds than on individual citizens. What can the Czech and Slovak experience teach?

Pragmatism should be the guiding principle. Too often privatization programs stall on methodological debates. Instead, the Czechs and Slovaks were pragmatic, using whatever method would achieve their privatization objectives most quickly. The coupon scheme was just one more tool in the government's tool-kit, which included a variety of more conventional tools as well.

Keep it simple. Besides ownership transformation, privatization is often asked to address regional development, unemployment, and fiscal problems. Under the first wave, the Czech and Slovak Governments used other policies to address these problems, relying on privatization only to create profitable private firms that would pay taxes and create jobs. The introduction of multiple objectives in the second wave of privatization in the Slovak Republic has been a major reason for delays.

Minimize government meddling in politically important firms. In most transition economies, there tend to be a small number of large insolvent firms, often in isolated locales, that almost inevitably get special treatment because of political importance. These firms are ill-suited to mass privatization and should probably be excluded. However, insolvency *per se* is not a good reason for exclusion since private owners are better than government at restructuring. Government even-handedness in the form of hard budget constraints is key for achieving improvements in enterprise performance.

Better information makes for better markets. The government made substantial information publicly available at the start of the process, which played an important role in determining share prices in the early bidding rounds. The special role of information becomes apparent when compared to some alternatives. In more centralized approaches, such as in Poland, public information is less important since the design of the program relies more on investment funds to be informed, to be diversified to protect citizens who own shares in funds, and to exercise governance. Where insiders (workers and managers) are major players in mass privatization schemes (such as in Russia), the information problem may be smaller (because insiders tend to already have considerable information about their firms), although the efficiency gains for stock markets that result from making information publicly available are not realized.

Sequential auctions allow bidders to learn. The use of a sequence of simultaneous bidding rounds both used and created information by forcing those with knowledge about enterprises' true values to reveal it to others. Consider some alternatives. A single simultaneous bidding round that allowed people to make multiple bids (thereby revealing their demand curve) could have been used, but that would have favored those with access to privileged information and generated no intermediary information for other bidders. Similarly an auction that was not simultaneous, but was conducted individually for each enterprise would not have generated the relative price information that facilitated the emergence of a market equilibrium.

Privatization is always political. Like most reforms, there are winners and losers, and the program's design must adapt to the political reality. In the Czech and Slovak Republics, there was a strong political commitment to an equitable process, there was an ability to overcome strong vested interests, and an administrative infrastructure and a citizenry existed with the capacity to implement a fairly sophisticated scheme. Conditions elsewhere may not be so favorable, meaning that political and administrative constraints will require simpler schemes, a greater need to placate powerful "insiders," and perhaps less equity among beneficiaries. ■

For more details, see the author's, "Making a Market: Mass Privatization in the Czech and Slovak Republics," World Bank Policy Research Working Paper 1231, December 1993, and "Information and Price Determination under Mass Privatization," World Bank Policy Research Working Paper 1305, June 1994.

Farm Reform in the Transition Economies

KAREN BROOKS AND ZVI LERMAN

THE CREATION of new farms on privately owned land holds the key to agricultural recovery in countries abandoning collectivized agriculture in favor of the market. The job to be done is mammoth, because the inherited collective farm is flawed as an organizational form for agriculture. Transfer of ownership must therefore be accompanied by farm restructuring, a process for which no well-tried formula exists.

For Central and Eastern Europe and the states of the former USSR, the past four years have brought the creation of millions of new private farms and the reorganization of thousands of farm collectives, dramatically altering the rural landscape. In some countries, the changes are visible to the eye of a casual traveler. In others, detailed farm surveys would be needed to capture the change, much of which is only partially implemented. The impetus for reform has been twofold:

- Agriculture is a very large sector in the region, with a share of 15–20 percent of total GDP and a correspondingly high share in total employment (see chart)—and thus efficiency gains will have both sectoral and macroeconomic impacts.
- Despite efforts to modify and improve the collectives during the late communist era, all countries in the region entered the period of reforms with large inefficient state and collective farms unsuited to produce competitively in the new market environment. (On state farms, the state owns land and assets. On collectives, the membership formally owns assets and, in some countries, land.)

The task is unprecedented in both scope and depth. The countries in the region represent around 20 percent of the world's farmland and 8 percent of the world's population. Thus, the potential impact of successful agricultural reform on world food supply and on growth in transition economies is large. There is, however, little previous experience or theory to guide policymakers in transforming the entire agricultural sector of a centrally planned economy to a market-oriented operation.

So far, these countries have tried a wide variety of reforms, although the results have produced more questions than answers about decollectivization—that is, breaking up large collectives into individual small farms or reconfiguring each as several autonomous business units. Collectives live on in most countries and have re-emerged even where privatization of land has been most complete, thus providing support for advocates of collective production. In contrast, the complete dis-

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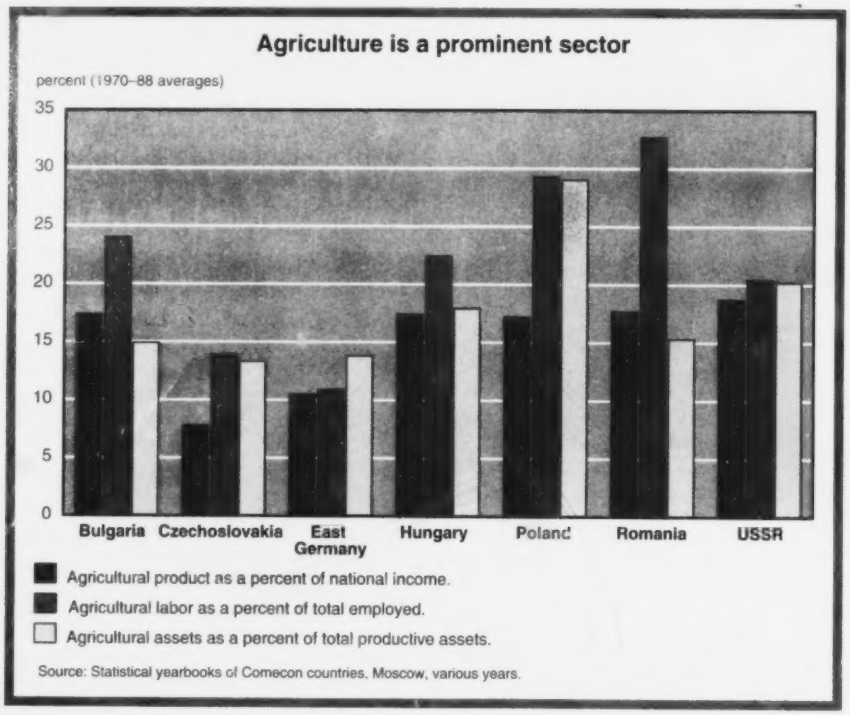

mantling of collectives in Armenia is credited with forestalling famine in the face of war and blockade. Agricultural production and sectoral earnings have fallen throughout the region—as subsidies are withdrawn and markets contract—both where changes have been the greatest and where they have been negligible. Land reform and the breakup of collectives have been blamed for the decline in production, as have lack of land reform and retention of collectives.

In the end, agricultural reforms must take a different tack than their counterparts in industry. Programs of industrial privatization have been consciously eschewing the time-consuming effort of restructuring prior to privatization, instead opting for rapid privatization and leaving restructuring to the new owners. But in agriculture, corporate farms are an exception rather than the rule, and separation between owners and operators is not as common as in industrial and commercial corporations. Formal transfer of ownership, therefore, has no real meaning in agriculture unless it is accompanied by regrouping of land and assets in units that can be owned or leased by operators.

The need for simultaneous restructuring and transfer of ownership in an environment not yet fully supportive of new kinds of farms is creating the tension and uneven progress on decollectivization observed in the region. Compounding matters is the fact that the process is driven by political, rather than economic, considerations, with the two often in conflict. As the various countries attempt to identify viable alternatives to the extremes of total fragmentation and preservation of the pre-reform structure, they may well find that there is no one optimal format as the target of the process of reform. Instead, several alternative farming structures may co-exist, ranging from family farms through partnerships of producers to larger corporate farms and cooperatives. The underlying features of all these diverse forms, contrary to traditional collectives, will be private ownership of productive assets, personal accountability, and an appropriate incentive system rewarding individual effort and motivating performance.

Inherited structure

Socialist agriculture was characterized by large collective and state farms, imposed on Soviet peasantry in the 1930s and extended to Central and Eastern Europe after World War II. In the Soviet Union, all land was nationalized within days of the revolution of October 1917. Albania began nationalizing land in 1944 although, in general, land in Central and Eastern Europe was collectivized but never completely nationalized. In Poland—the only country in the region that escaped all-embracing collectivization—only 20 percent of the land was collectivized. Outside of Poland, however, few private farms survived the socialist reorganization of agriculture. Over the years, property rights in the socialist economies became a mere formality. Land markets were abolished, and, in line with Marxist economics, the value of land was not included in production costs, even though nominal rents were paid to notional owners in some countries.

Although the region is rich in resources, socialist agriculture suffered from relatively low productivity and was increasingly unable to deliver the expected sectoral contribution to aggregate growth. At the end of the socialist era, the sector was receiving substantial subsidies, and net food imports into the region were large. These deficiencies were partly due to disincentives inherent in collective production. Members of production cooperatives or state farms had little incentive to work well and little accountability for costs. The traditional obligation of cooperatives to find work for all members led to overemployment. Farm managers had little authority over business decisions, and the banking system exercised virtually no financial discipline. The use of labor and capital was inefficient: the shares of capital and labor used in agriculture were higher than the share of agricultural output in national income (see chart).

Despite pervasive collectivization and the virtual absence of a traditional private farming sector, individual production survived in all countries (except Albania) in the form of household farms, where members and employees of collectives, as well as some urban residents, farmed part time. These farms cultivated about 10 percent of agricultural land in Bulgaria, Czechoslovakia, and east Germany; about 15 percent in Romania; and nearly 20 percent in Hungary. In the USSR, about 2 percent of farmland was set aside for household plots and gardens.

The classic Soviet-type collective farm in its mature form had little in common with any farm type in a market economy, whether family, corporate, or plantation. Decollectivization thus requires re-creation of new farm structures, as well as transfer of ownership.

Methods of reform

Land reform in the former socialist world is evolving in two basic ways: *restitution* to former owners and *distribution* to individual users (see table). Under restitution, ownership rights before collectivization are recognized, and beneficiaries usually receive a physical plot of land and a registered title. Distribution, on the other hand, is a two-stage process. Once the eligible recipients are defined, the land is first divided into paper certificates of entitlement. Then the physical allotment represented by the paper share must be identified and registered, and title documents issued.

Private ownership was legally reinstated throughout Central and Eastern Europe in 1990–92. In the USSR, the right of private individuals to own land was recognized by 1991 legislation at the national level and subsequently incorporated in the land codes of many of the former republics, although legal rights of private land owners are still restricted or ambiguous in some.

Restitution versus distribution. Most of Central and Eastern Europe has pursued a strategy of restitution, although some countries (Hungary and Romania) also provide for land distribution to current individual users. In Albania, however, only the current users participated in the distribution of land, and former owners were compensated by a special issue of state bonds. At the other extreme, Bulgaria and the Czech and Slovak Republics mandate returning collectivized land to former owners, while workers in collectives may be allotted land for farming without ownership rights.

In the states of the former USSR, land is being distributed to farm members and employees. The major issues are eligibility and whether and how land rights should be translated into physical ownership. Land shares are normally distributed without payment to members and workers in collective and state farms (including pensioners) and some other categories of rural residents. Only the Baltic states are now reinstating pre-collectivization ownership, although initially (in 1989–90) land was distributed to users. Restitution is publicly debated in Moldova and in western Ukraine, where collectivization took place only in the 1950s, but it is not reflected in these countries' official approaches to land reform.

The transfer of ownership has proceeded fairly rapidly only in countries that dismantled collective farms outright, for example, Albania and Armenia, where land was divided and distributed directly to employees, and Romania, where land was quickly restored to former owners. Where distribution has occurred in two stages, progress has been slower, hindered by technical issues (e.g., clarifying boundaries of farms and counties) and the obstacles to resolving these in an environment in which political opposition to decollectivization remains strong.

Where transfer of ownership has moved rapidly, holdings of 2–10 hectares, some of which are fragmented, have proliferated. In view of this new distribution, full functioning of land markets to allow consolidation of holdings through sale or rental is essential if mid-size commercial farms are ultimately to emerge. The limitations on selling and leasing land are especially constraining in such an environment.

Farm restructuring. Privatization of land is linked to various procedures for distributing the assets of collective and state farms. The recipients are predominantly members and workers who contributed by their labor to accumulation of assets over the years. In some cases, the contribution of former owners whose assets were absorbed into collectives is also recognized. As entitlement is shifted, the land and assets must be regrouped by those who intend to continue farming the land. Regrouping occurs either through individual transactions, for example, through leasing or sale contracts when allowed, or through voting and agreements, when individuals accept a new role in the existing collective or create a new organizational structure.

Restructuring is proceeding along several different tracks. Under the most conservative and easiest procedure, land and assets are distributed to individuals, in the form of paper shares or in kind; the new owners remain in the old collective or reconstitute it. The collective may change its name to a joint-stock society or a similar organizational structure but continues functioning as before.

At the opposite extreme are farms where members or employers completely dismantle the old structure and distribute all land and assets to individuals. The large farm is broken up into family units, each with its allotment of assets, possibly in cash equivalent form, and land. A few hundred private farms are thus created in place of one collective farm. This approach was adopted in Albania, Armenia, and Romania, where all collective farms were rapidly disbanded and divided into private farms during 1991. In other countries, dismantling is rare. In Russia, of 21,000 farm enterprises that reorganized by January 1993, only 268 broke up completely into private farms.

Independent farms. Private farms are also created when individuals leave the collective with a share of land and assets and start an independent family farm. The number of such farms is growing at an impressive rate even in countries that do not follow the dismantling strategy: as of mid-1994, there were approximately 300,000 in Russia and 30,000 in Ukraine. The private farms average 40 hectares in Russia and 20 hectares in Ukraine, compared with several thousand hectares in an average collective or state farm. In Central and Eastern Europe, restitution and farm-dismantling policies have produced private farms ranging from 1 hectare in Albania to 10 hectares in Hungary and Poland.

Despite the increase in their numbers, private farms still account for a small percentage of agricultural land and agricultural production in most countries (the only exceptions are Albania, Armenia, and Romania). Private farmers are concerned about high prices for inputs and high interest rates—which are perceived to be an obstacle to purchasing machinery, constructing farm buildings, and developing their farms.

Hybrid structures. A number of farm types combining features of the old collective and the new family farm have also emerged. The new private farmers sometimes combine to form a producers' association. In some associations, each farm retains its identity, but all farms cooperate in providing services and in certain other activities. In other associations, private farmers may pool their plots and form a partnership. Several partnerships or associations in the same region may in turn join to form service cooperatives. In Romania, 48 percent of land originally distributed to private farms is now in various farmers' associations. Half the recipients of land through restitution in Bulgaria and a large proportion in Hungary have also chosen to join cooperatives.

A similar structure evolves when the old collective, instead of being dismantled into hundreds of private farms is reorganized internally into a system of relatively small autonomous profit centers. The reorganization can be accomplished through leasing arrangements within the old farm or through transfer of ownership of assets directly to new entities created through farm restructuring.

This approach differs from the distribution of shares to individuals in that the shares are regrouped into business units before ownership is transferred. Under this model, agricultural production is concentrated in units that are small enough to maintain personal involvement and accountability; farm support

Restitution or distribution?

Central and Eastern Europe	Restitution to former owners and distribution to workers
Albania	Workers
Bulgaria	Former owners
Czech and Slovak Republics	Former owners
Hungary	Former owners and workers
Romania	Former owners and workers
States of the former USSR	**Predominantly distribution to workers**
Baltic states	Restitution to former owners
Russia and other former republics	Distribution to workers

services, such as purchasing, marketing, and credit, are provided by service cooperatives or specialized firms created in the reorganization. This structure provides a natural solution to the needs of pensioners or other shareholders who do not wish to continue farming. Each production unit, in addition to its active member-owners, may accept land and asset shares from inactive investors, who will be entitled to dividends from the unit's profits. Leasing arrangements can also allow pensioners to receive income from their land and asset shares. Similar organizational solutions are observed across the region, from Hungary to the states of the former USSR.

How reforms fall short

Current legislation in all countries circumscribes owners' rights in transferring and using land and the size of holdings. Restrictions are generally intended to create owner-operated farms and prevent absentee ownership, or in some cases to protect new landowners from losing their land to speculators. These restrictions—which reflect fundamental ambiguity about private property in land, particularly the functioning of land markets—are gradually being relaxed as the role of marketability of land (as distinct from simple ownership) is more fully understood.

Even after ownership is transferred, it can take a year or longer to have parcels surveyed and registered, and title documents issued. Without title, private farmers have difficulty approaching banks for credit. Where land is divided into paper shares while remaining collectively owned, normal lending through mortgage collateral is slow to develop. Land reform has not yet realized one of the benefits of private ownership that is a necessary first step toward increased lending to agriculture: to facilitate access to credit by providing universally acceptable collateral.

In principle, the "shareholders" in a reorganized collective farm should be motivated to adopt a profit orientation so as to maximize dividends on their shares, but the new incentive structure has not yet been implemented in these organizations. Neither dividends nor shares have much practical significance, and in many cases the shares are not tradable. In the absence of an appropriate incentive structure, no true sense of ownership is created, and the shareholders continue working as salaried employees under the direction of their previous collective manager.

Although these "new-old" structures are often expected to be more efficient because of their modern-sounding names and new charters, they in fact retain the weaknesses and inefficiencies of collectives. Many cooperatives continue to ensure work to all member-owners, thereby perpetuating overemployment. This approach, referred to as "changing the sign on the door," was frequently observed in some states of the former USSR in the earliest period of farm restructuring.

In many new associations, shareholders and members have a stronger sense of property rights than in the cosmetically reorganized but fundamentally unchanged collectives. In most, however, land is currently pooled, either in management or in ownership, and these farms continue to produce collectively and provide services cooperatively. In this respect, they differ from Western farmer cooperatives or Israeli moshavim, where production is private and cooperation is restricted to shared services. Over time, these organizations can be expected to evolve further and increasingly delegate production to individuals and partnerships, while the cooperative specializes in services.

"Given the full magnitude of the changes required to create a market-oriented agricultural sector, it is not surprising that reform has been uneven and the results disappointing."

Prospects for the future

The changes in land ownership and farm organization throughout the former socialist world since 1991 are diverse and remarkable in their scope. A variety of organizational forms are emerging, and it is too early to judge which forms will perform best in the new environment. The changes offer optimism that the new property rights and organizational forms needed for market-oriented agriculture can be created. However, they have also generated disappointment and disillusionment, largely because the role of land reform and farm restructuring in the overall agricultural transition has been poorly understood. The expected supply response will come not through the registration of private farms and other new structures, but through their operation, which requires links to input, product, and financial markets.

Moreover, if the incentive environment is signaling contraction of the entire sector, abandonment of particular activities, or relocation of production out of high-cost regions, a responsive private agriculture will contract, either locally or nationally. Bankruptcy that leads marginal producers to leave farming may indicate success in farm restructuring, rather than failure and justification for retaining collectives. After a first wave of substantial progress in creating private farms, governments should prepare to confront the natural backwash of bankruptcy among new farmers. Governments are under intense pressure to intervene to save the failing collectives and the private farms, and this can lead to inconsistent policy interventions.

Governments do have an important role to play in land reform and farm restructuring. The role is less dramatic than a rescue mission, but more difficult, because it requires steady progress toward creating a supportive market framework for agriculture. In the area of macroeconomic and sectoral policy, governments must control inflation, provide exchange rate and trade policies that give agriculture access to world markets, and wind down subsidies to inefficient producers. They must also implement programs to privatize marketing and input supply, and introduce financial sector reforms, so that new farms can function effectively. When properly managed, the combination of policies and programs puts a hard budget constraint on traditional farms and then shows an emergency exit through restructuring.

Given the full magnitude of the changes required to create a market-oriented agricultural sector, it is not surprising that reform has been uneven and the results disappointing. The progress on defining and implementing programs of land reform and farm restructuring represents an investment in future growth. This investment must be supported through continued implementation and complementary measures in macroeconomic policy, sectoral policy, and structural reform if it is to yield a substantial return. Where much of the complete reform package (policy, ownership, and institutions) is moving into place, as, for example, in Hungary, there are grounds for optimism that the parts can indeed function together and agriculture can rebuild through markets. ■

For further details, see "Land Reform and Farm Restructuring in Russia," by the authors, World Bank Discussion Paper No. 233, 1994.

Multiple Exchange Rates: The Experience in Arab Countries

MOHAMED A. EL-ERIAN

SEVERAL countries have used multiple exchange rate regimes to address balance of payments difficulties. As some Arab countries have found, this strategy has considerable costs and provides a poor substitute for a realistic single rate supported by sound economic and financial policies.

Multiple exchange rate (MER) regimes —which involve the adoption of different exchange rates for different transactions— have featured at one time or another in the arsenal of economic policy instruments of a few industrial countries and several developing countries. MERs have been attractive to policymakers in these countries as instruments to "fine-tune" the economy because they can encourage certain transactions and penalize others through what effectively amounts to a set of taxes and subsidies.

Some countries have used MERs as an adjunct to monetary policy. External current and capital account transactions have been channeled through different exchange markets in an attempt to isolate the domestic economy from what were viewed as transitory and potentially destabilizing speculative capital flows. In other countries, however, such as the Arab countries discussed below, the focus has been different. MERs have been adopted to meet a range of objectives: to promote earnings from exports of goods and services; to discourage certain private sector imports and service transactions; to make government purchases of foreign exchange for imports and debt servicing less costly; and to subsidize imports of certain basic consumer goods.

But such regimes have more drawbacks than advantages, especially over the medium and long term. MER regimes can severely distort economic incentives and impose costs on the economy by misallocating production and consumption resources. Moreover, attempts to subsidize essential commodities through the exchange system rather than through more transparent budgetary subsidies tend to obscure the underlying costs while imposing distortions elsewhere in the economy. The "gain" to the budget under MER regimes is usually offset by central bank losses and/or implicit taxes on private sector foreign exchange activities. Eventually, foreign exchange pressures re-emerge, manifesting themselves either directly, through losses of official international reserves, or indirectly, through a growing informal sector. These issues assume greater importance when administrative and institutional systems are weak, and scarce administrative resources need to be directed toward sustaining the MER-imposed segmentation of the exchange market, fighting evasion by guarding against overinvoicing of imports and underinvoicing of exports, and processing foreign exchange license requests.

To date, analysis has focused primarily on the experiences of countries in Latin America and Asia, with little attention paid to Arab countries. But lessons may be learned from their experiences as well. Over the last 20 years, several of these countries have implemented MER regimes. Some of them have been dismantled subsequently as part of comprehensive economic reform programs. These countries' experiences reinforce the conclusion that, although MERs may help countries achieve certain policy objectives over the short term, they ultimately introduce more problems than they address.

MERs in Arab countries

Over the last 20 years, a number of Arab countries, including Algeria, Egypt, Jordan, Morocco, Sudan, Syria, and Yemen, adopted MER regimes to try to influence current account transactions and lower the foreign exchange costs of the public sector. Such systems are still in place in Sudan and Syria. Other countries in the region, particularly the oil economies of the Cooperation Council for the Arab States of the Gulf —which were not similarly constrained by a lack of sufficient foreign exchange earnings— have maintained unified exchange rates.

For countries that resorted to an MER regime, the basic policy motivation was broadly similar—to counter the adverse

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impact on external current account transactions of an overvalued exchange rate while containing budgetary costs. However, implementation varied, and this affected the ease with which the regimes were subsequently reformed. There were two main approaches to implementation.

The first, relatively simple approach centered on establishing a premium above the official rate for certain transactions (e.g., Jordan and Morocco) to promote certain exports and subsidize a small number of imports. In the second, more common approach, the MER regime evolved into a complex and fragmented system of foreign exchange pricing (e.g., Egypt, Sudan, and Syria). The exchange rate system generally consisted of separate rates for current transactions. At certain times, the same transaction could be subject to different rates depending, for example, on whether it was effected by the public or the private sector. This regime was supported by a relatively complex system of controls over international transactions and requirements for surrendering foreign exchange. It helped perpetuate an inwardly oriented economic system dominated by the public sector—a system that proved to be less adaptable to changes in international economic and financial conditions.

In both approaches, although the MERs were intended to be temporary, they remained in place longer than anticipated despite adaptations in coverage and implementation procedures. Complex regimes, in particular, proved much more difficult to remove, and attempts to modify them sometimes had the opposite effect. For example, in the 1980s, some Arab countries introduced a new exchange rate as a way of achieving a partial effective devaluation—that is, a devaluation relative to the weighted average of the different exchange rates prevailing in the economy. This was done in the context of a transition to a unified rate at a realistic level. However, with considerable financial imbalances continuing to prevail, the additional rates became limited in scope, requiring new transitional procedures but with a larger number of rates. Similarly, attempts to influence the rate in the parallel market by legalizing it in order to limit the depreciation were frustrated as other informal markets sprung up, even outside the borders of the country in some cases (as in Sudan).

Several Arab countries have recognized the limitations of these fragmented systems and have moved away from MERs. Ad hoc measures that involved transitional exchange rates and shifting products among different exchange markets have given way to more concerted efforts to unify the exchange rate as part of a broader adjustment and reform effort aimed at achieving high economic growth and financial stability. Egypt and Sudan's exchange rate unification attempts in the early 1990s provide important insights into the ingredients for, and obstacles to, success in reforming exchange rate regimes.

"...although MERs may help countries achieve certain policy objectives over the short term, they ultimately introduce more problems than they address."

Egypt's experience

Perhaps the most striking reform of the exchange system in Arab countries is that undertaken by Egypt. After 20 years under a complex and well-entrenched MER regime, Egypt moved decisively in 1991 to unify its exchange rate in the context of a comprehensive adjustment effort.

Egypt introduced an MER system in 1969 to encourage tourist receipts, workers' remittances, and related capital inflows in the context of pressures on the country's foreign exchange position. Premia and surcharges were applied to the official exchange rate. The MER system, formalized in the early 1970s, was used to provide foreign exchange to the public sector at an appreciated (cheaper) rate and thereby subsidize the price of imports of essential consumer commodities. Since it could normally buy foreign exchange to pay for imports and debt service at an appreciated exchange rate, the public sector benefited from an important subsidy. Private sector activities were effectively relegated to a residual role in many areas, consistent with the emphasis in the 1960s and early 1970s on the public sector as the engine of production, investment, and growth.

The system evolves. By 1973, Egypt's exchange rate regime formally consisted of two exchange rates: an official rate and a centrally determined "parallel market" rate. The exchange rate in the new parallel market was set with a view to attracting workers' remittances and encouraging tourism. Subsequently, the authorities adopted a third rate, resulting in the following structure: a central bank pool reserved mainly for central government operations; a more depreciated commercial bank pool for the transactions of public enterprises; and the most depreciated rate, the free market pool, for private sector activities. In response to the dramatic changes in the nature of the country's foreign exchange earnings following the increases in international oil prices, this structure was supplemented by an "own exchange" pool that allowed residents who possessed their own foreign exchange to import goods for their own use. The pool was aimed at utilizing the foreign exchange earnings of the significant number of Egyptians working abroad, particularly in the neighboring oil countries.

Difficulties prevail. How the Egyptian exchange rate system evolved in the 1970s and 1980s had much to do with policymakers' attempts to address conflicting policy objectives—the most prevalent being the conflict between the desire to subsidize certain public sector transactions and the need to reduce distortions that were undermining the economy's external sector performance. Among the distortions were those associated with the MER system itself. The need to reconcile these policy objectives was accentuated by the demands of a rapidly growing population and by the country's vulnerable foreign exchange situation.

Difficulties in reconciling the different policy objectives were reflected in frequent adap-

tations in the basic structure of the MER regime. In 1979, the central bank and commercial bank pools were unified; in 1981, premium rates were introduced; in January 1985, imports by those who already had foreign exchange were prohibited and then restored three months later. Finally, in 1987, a new bank market was introduced. The administrative difficulties that the authorities faced in separating the various exchange markets and countering arbitrage-induced flows made the country's problems worse. By 1990, it became clear to the Egyptian authorities that a bolder approach to exchange rate reform was necessary if the country was to succeed in overcoming its financial imbalances and place the economy on the road to a viable external payments position.

Unification. In November 1991, about nine months after reducing the number of exchange rates from three to two, Egypt unified its exchange markets. The reform of the exchange system was part of a comprehensive economic and financial program that encompassed, among other measures, significant fiscal adjustment, interest rate reforms, and tight credit policies.

The exchange market reform component had two essential elements: first, to price foreign exchange at a level consistent with underlying demand and supply conditions; and second, to simplify the system of quantitative exchange controls and reduce the economic and administrative features that had led to distortions in production and consumption.

The reform helped strengthen Egypt's domestic and external financial balances, reverse currency substitution, and attract significant capital inflows. Specifically, in combination with the substantial reduction in the fiscal deficit and reform of the interest rate structure, the rationalization of the exchange rate system contributed to a sharp improvement in Egypt's gross international reserves from $2 billion in June 1990 to $14 billion (equivalent to 15 months of imports) in June 1993. At the same time, inflation—measured by the consumer price index—fell from 21 percent in 1989–90 to 11 percent in 1992–93. Finally, the adjustment process and the country's creditworthiness received a boost from the conclusion, under the auspices of the Paris Club, of a comprehensive debt reduction agreement with Egypt's main official bilateral creditors.

Sudan's experience

Sudan was faced with domestic and external circumstances much more unfavorable than Egypt's, and reform policies in 1992–93 were unable to overcome the substantial distortions that had arisen under the MER system.

After many years under an MER regime, Sudan introduced, in February 1992, a unified exchange rate system to replace the system based on the official exchange market, the free market, and the retention market for exports of goods and services. All of Sudan's foreign exchange transactions were moved to the unified rate with the exception of a transitional arrangement (until May 1992) for selected investment goods. As with Egypt, this unification followed several previous adaptations, most of which were a response to the underlying tensions associated with assigning too many policy objectives to the exchange rate instrument. The Sudanese Government viewed this action as a key element for improving the efficiency of the foreign exchange regime, consistent with efforts to improve economic and financial performance—this at a time of severe external payments pressures, reflected in low foreign exchange reserves (equivalent to less than one week of imports), reduced import availability, and high and mounting external payments arrears.

The government could maintain the new unified rate only by tightening demand-management policies significantly. This involved sharply reducing the budget deficit (which amounted to 18 percent of GDP in 1991–92) and containing domestic liquidity. However, the tightened financial policy stance could not be maintained, and in the face of a difficult external environment and domestic sociopolitical problems, pressures re-emerged in the exchange market.

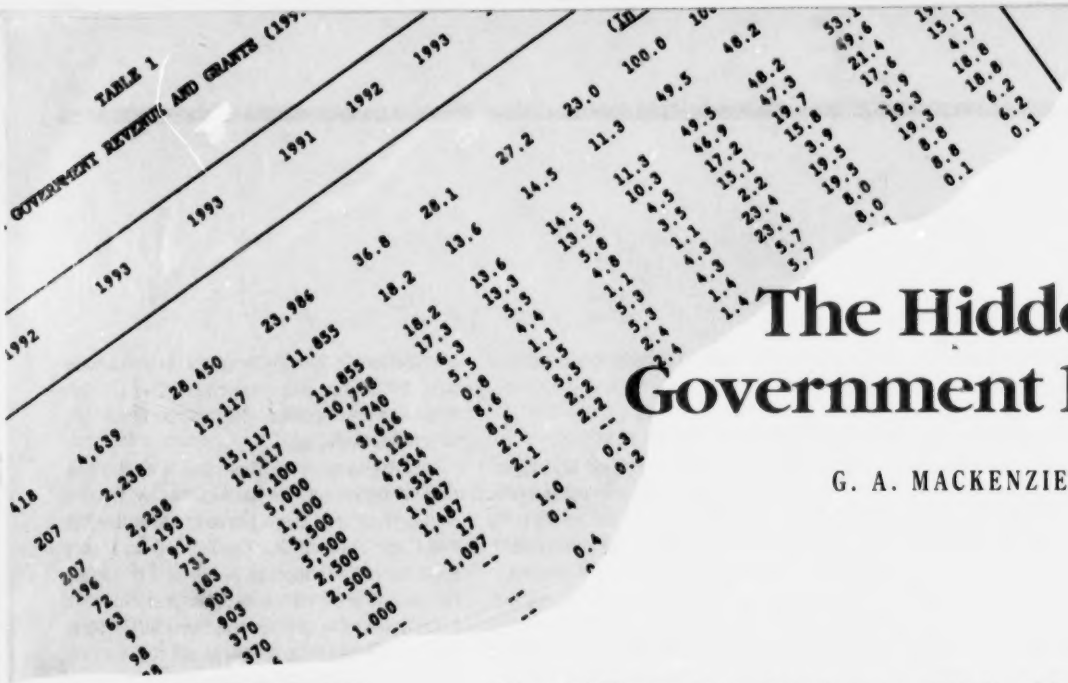
Rather than opting for greater flexibility in setting the unified rate, in part because of concerns about the domestic price implications, the authorities restored the MER regime. In October 1993, a dual exchange rate system was introduced based on an official market rate and a commercial bank rate. The more depreciated commercial bank rate was applied to all private sector imports and invisible transactions, while government imports were paid for at the more appreciated rate. This approach re-introduced the differential pricing of foreign exchange.

Sudan's experience illustrates both the conditions necessary for moving away from a well-entrenched, distortionary, MER regime and the difficulties policymakers may encounter in attempting to do so. The higher the initial level of distortions and financial imbalances, the greater the need for government resolve to support exchange rate unification by an early and sustained tightening of fiscal and monetary policies. And the need to tighten financial policies is accentuated if exogenous factors are unfavorable—albeit rendering it more difficult to sustain.

Some lessons

The analysis of MER regimes in the Arab countries adds to the lessons drawn from the experiences of countries in other regions. As in other economies, the effectiveness of exchange rate policy in some of these countries was weakened by what amounted to an overburdening of this economic management instrument under MER regimes. Countries' attempts to influence current account transactions, and to limit budgetary costs through the use of MER regimes, were undermined by the inability to address comprehensively the underlying financial imbalances. As a result, rather than correcting the fundamental problems, MER regimes tended to introduce additional policy complications.

Recognizing the economic costs of MERs, Arab countries undertook to reform the exchange rate system. Earlier attempts were frustrated by the inertia and large-scale subsidies that had emerged and grown under the MER regimes, as well as by the persistence of large financial imbalances that undermined the policy effort. More recent exchange system reforms have again highlighted the importance of supporting the adoption of a single rate with solid domestic economic and financial policies. The sustainability of the reforms in the context of high medium-term economic growth and financial stability will continue to depend on progress in containing aggregate demand pressures and broadening structural reform to enhance the investment, production, and social sector performance of the economy. ■



The Hidden Government Deficit

G. A. MACKENZIE

PUBLIC sector operations can go well beyond the traditional scope of government. When public financial institutions get involved in deficit-creating or distortionary activities of a kind that should really be handled through the budget, such activities—called quasi-fiscal operations—can hurt the economy and be costly as well.

It may not be widely known, but many central banks, other public financial institutions (PFIs), and government-owned enterprises—not just the "narrowly defined government" (e.g., the treasury and state governments)—play a key role in fiscal policy. They do so by granting interest rate subsidies and exchange rate guarantees, operating multiple exchange rate arrangements, and providing cheap finance for the government.

These so-called quasi-fiscal activities are worrisome because they are not transparent—the transactions are in effect hidden in the accounts of the central banks or other PFIs, which undoubtedly explains much of their appeal. They are also worrisome because they can prove to be quite costly (see table). In fact, the deficit resulting from the quasi-fiscal operations of PFIs can exceed the deficit of the rest of the public sector. Moreover, by acting as surrogates for taxes or subsidies on selected activities, these operations can have an important impact on prices, the level of economic activity, and the balance of payments. At the same time, they can affect the allocation of resources in the economy between the public sector and the private sector, and within the public and private sectors.

Just how serious is the problem? Some countries have been able to deal with even quite entrenched quasi-fiscal activity. In

Quasi-fiscal activities can cost central banks a bundle

Operating losses or profits of public financial institutions in selected countries
(percent of GDP)

	1986	1987	1988	1989	1990	1991	1992	1993
Argentina [1]	-1.6	-0.9	-0.5	-4.5	-0.7	-0.4	-0.1	0.1
Bulgaria								
Profits transfer to the state budget [2]	--	--	--	2.1	1.2	4.0	1.9	3.0
Jamaica [3]	-6.9	-5.7	-5.1	-5.4	-4.9	-4.3	-5.2	-5.2
Philippines [4]	--	-1.4	-1.9	-2.0	-1.8	-1.5	-1.3	-0.7
Poland								
Profits transfer to the state budget [5]	--	--	--	3.0	3.6	1.8	1.7	1.3
Uruguay [6]	--	--	--	-4.3	-4.5	-2.9	-2.0	--

Sources: Argentine government officials; Bank of Jamaica; Philippine government officials; Polish government officials; Central Bank of Uruguay; and IMF staff estimates.

[1] Central Bank of the Republic of Argentina.

[2] Bulgarian National Bank

[3] Bank of Jamaica. Fiscal years ending March 31.

[4] Includes Philippine National Bank, Development Bank of the Philippines, Philguarantee Corporation, Land Bank, and Central Bank of the Philippines.

[5] After 1988, including payments of enterprises' income tax by the banks and transfers from the National Bank of Poland. For 1989, including revenues from foreign currency auctions.

[6] Includes Central Bank of Uruguay, Mortgage Bank, and banks taken over by the Central Bank. Excludes the Bank of the Republic.

--: Data not available.

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others, the problems persist and may even have worsened. In many economies in transition, for example, loss-making establishments are routinely bailed out by the banking system. But serious problems are by no means the preserve of these economies, as the experience of countries around the world attests.

Why resort to quasi-fiscal?

Quasi-fiscal activities—operations carried out by a central bank or other PFI whose effect can in principle be duplicated by budgetary measures in the form of an explicit tax, subsidy, or direct expenditure—are most often carried out by central banks (on behalf of the government) because they have both the motive and the opportunity.

The opportunity comes from their special role as regulator of the exchange rate and financial systems, and as banker to the government. Cash-strapped governments might try to lower foreign debt service costs and reduce the cost of essential imports by asking the central bank to set more favorable exchange rates for these types of transactions, or to draw in vitally needed foreign exchange through exchange rate guarantee schemes. Governments may have other objectives, such as supporting agriculture or a rapid industrialization program, and call upon the central bank to offer preferential credit for these activities.[1]

Although other PFIs do not enjoy the same opportunity as central banks for quasi-fiscal activity, just being a public sector entity may enable them to be used for fiscal policy ends. Even nonfinancial public sector enterprises are often called upon to set prices for certain commodities at a level that entails an implicit subsidy. In some countries, they have been obliged to hold deposits earning below market rates of return at PFIs, which allows the government-owned banks to give subsidized loans for certain activities the government wants to promote (e.g., agriculture and exports). Subsidized lending is probably the most common form of quasi-fiscal activity for a PFI other than the central bank. However, unlike central banks, these PFIs typically are not in a position to levy quasi-fiscal taxes—meaning that their quasi-fiscal operations, on balance, tend to be loss-making.

Central banks and other PFIs have a number of motives for engaging in quasi-fiscal activity. These activities can hide what are essentially budgetary activities (when the central bank lends money to the treasury at no interest, the government's interest bill is artificially reduced). They may be more convenient to administer (if a central bank is used to operating a multiple exchange rate system, it may seem easier to rely on it than on the budget to extend a subsidy to an imported good). Finally, some of the quasi-fiscal operations of central banks (notably rescue operations for troubled financial institutions) may reflect an assumption that such support for the financial sector is properly in the domain of the central bank.

The exchange rate game

Quasi-fiscal activities involving the exchange rate can take a myriad of forms. Generally they can be divided into those that result from the use of multiple exchange rates and those that result from the assumption of exchange risk by the central bank.

Multiple exchange rates (MERs). At the end of 1992, some 49 countries had at least one exchange rate other than the official rate for some transactions categories. Nearly all of these required the surrender or repatriation of export proceeds, a practice tantamount to a tax when the surrender rate differs from the market rate. The fiscal implications can be very important.

One type of problem arises when a special rate applies to special classes of exports and imports. For example, if the rate is more appreciated than the official rate, in effect, the imports are subsidized, and the exports are taxed. In Egypt, a simultaneous tax/subsidy scheme operated through the foreign exchange system prior to the exchange system reforms of 1991. An appreciated exchange rate applied to exports of petroleum, cotton, and Suez canal dues, thus taxing them. The same rate applied to, and subsidized, imports of certain foodstuffs and external public sector debt payments. In Costa Rica, an import subsidy for medicines, medical equipment, petroleum products, and public external debt service that was in effect in the late 1970s and early 1980s took the form of a specially appreciated exchange rate for these items.

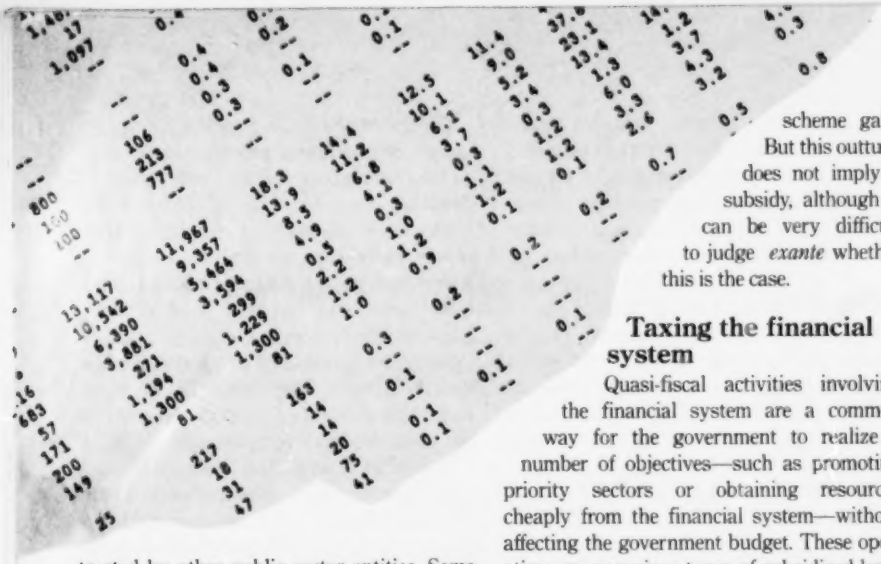
Another—and far more difficult to quantify—problem arises when the exchange rate is clearly far out of line with the domestic price level, as its maintenance entails both massive taxation of the exporters who are obliged to remit their foreign currency earnings at the official rate, as well as what can be an enormous subsidy for those lucky enough to receive foreign exchange at that rate. Up until the currency reform that took place at the beginning of 1986, the prevailing exchange rate regime in Guinea entailed a dual tax-subsidy of this type. Measuring the amount of the tax and subsidy involved in such cases is very difficult, however, because it calls for a judgment about the appropriate level of the exchange rate.

Clearly, MERs have a strong budgetary impact, because they effectively hide what for all intents and purposes are taxes and subsidies in the accounts of the central bank—essentially shifting the cost of these operations and the budget deficit from the government to the central bank. Moreover, these taxes and subsidies have a strong impact on the economy, which is not captured in either the accounts of the central bank or the government (see "Multiple Exchange Rates: The Experience in Arab Countries" in this issue). MERs can seriously distort a country's productive structure, creating very high rates of protection for some industries, just as tariffs do. They can also distort measures of the various components of government revenues and expenditure, and the fiscal role of public sector agencies.

Exchange rate guarantees. Many central banks have at one time or another used these as a means of acquiring foreign exchange. Typically, guarantees have been offered on the repayments of principal and interest of foreign-currency denominated loans. In some cases, exchange rate guarantees can entail a massive subsidy to the borrower. To take an extreme example, a guarantee may be given to maintain the exchange rate at which debt-service payments are converted at the rate prevailing at the time the loan or debt was contracted. Such a guarantee means, in effect, that the borrower pays an international rate of interest on a claim denominated in domestic currency. If domestic interest and inflation rates are high by comparison with international rates, the borrower can reinvest the proceeds at a substantial profit.

As long as the exchange rate holds at the rate prevailing when the loan was contracted, the operation has no effect on the income of the central bank. Once a devaluation takes place, however, the central bank starts realizing losses. The Bank of Ghana experienced quasi-fiscal losses in the 1980s as a result of its earlier assumption of the foreign exchange risk of certain loans con-

							4.8
							9.8
							15.1
							4.7
							18.8
						49.3	18.8
						8.8	6.2
						8.8	6.2
					0.1	0.1	0.1
					1.0	3.5	4.6
				1.2	0.6	--	--
		--	--	1.2	0.6	--	--
		--	--	1.2	0.6	--	--
		0.8	0.1	0.7	--	2.8	0.4
		0.1	0.2	0.7	0.3	0.4	0.9
		0.1	0.7	--	--	0.4	3.2
		--	--	--	--	--	--
		14.4	12.5	11.4	49.8	51.2	46.1	49.9
		11.2	10.1	9.0	37.8	40.0	37.1	39.0
	.5	6.8	6.1	5.2	23.1	24.1	22.5	22.8
	4.9	4.1	3.7	3.4	13.4	14.7	13.6	15.0
	0.5	0.3	0.3	0.3	1.3	1.2	1.0	1.2
	2.2	1.0	1.1	1.2	6.0	3.7	4.2	5.1
.300	1.2	1.2	1.2	1.2	3.3	4.3	4.6	5.4
81	1.0	0.9	0.1	0.1	2.6	3.2	0.3	0.3
25	217	163	0.3	0.2	0.2	0.2	0.7	0.5	0.8	0.7
3	18	14	--	--	--	--	--	0.1	0.1	0.1



tracted by other public sector entities. Some years intervened between the Bank of Ghana's assumption of the exchange risk and the realization of the loss. The losses realized by the Bank of Chile from a guarantee on a foreign exchange resale scheme contributed to its quasi-fiscal deficits in the mid-1980s.

The key aspect of exchange rate guarantees and some other quasi-fiscal operations is their contingent nature. The guarantee only has an effect on central bank income—measured on a cash basis—if the exchange rate depreciates. Similarly, a loan guarantee only affects the accounts of the central bank if the borrower defaults.

Since the exchange rate guarantee starts stimulating domestic investment, as well as distorting investment decisions, from the moment the debt is contracted, its macroeconomic and allocative effects predate its impact on the accounts of the central bank. The contingent feature of exchange rate guarantees does not distinguish them from the off-budget loan guarantees that may be extended by the central government, but in both cases the subsidy element is effectively obscured. When such operations are sizable, the normal cash-based measure of the government's financial operations becomes a less reliable indicator of the stance of fiscal policy. Loan guarantees can be justified on economic grounds in certain circumstances, but there is a *prima facie* case for ensuring that their subsidy element is properly accounted for, and not imposed on the central bank.

Exchange rate guarantees do not necessarily create losses, however. As long as the guarantee is given in return for the payment of premiums that are set at a level that adequately reflects the risk involved, participants in the scheme, although benefitting from the elimination of the exchange risk, do not receive a subsidy. After the fact, if the exchange rate depreciates more than expected, the central bank makes losses, and the participants in the scheme gain. But this outturn does not imply a subsidy, although it can be very difficult to judge *exante* whether this is the case.

Taxing the financial system

Quasi-fiscal activities involving the financial system are a common way for the government to realize a number of objectives—such as promoting priority sectors or obtaining resources cheaply from the financial system—without affecting the government budget. These operations cover various types of subsidized lending, credit ceilings, and reserve requirements. Central bank rescues of troubled financial institutions are also an important form of quasi-fiscal activity.

Subsidized credit. This activity can take many forms, of which the most transparent is lending at administratively prescribed and below-market rates. Other forms include preferential rediscounting; lending at normal rates of interest to poor credit risks; or the granting of poorly collateralized loans. Typically, the central bank does not lend directly to the final borrower—this role is instead often played by other PFIs that specialize in sectoral lending, like agricultural or mortgage banks—and the central bank may or may not support the sectoral lending institutions. In Uruguay, for example, the Central Bank has in the past lent substantial sums of money to the Mortgage Bank to finance its lending for low-cost housing. Current lending does not involve a subsidy element, although the Bank's portfolio still includes subsidized loans. Until recently, the agricultural bank in Turkey partly financed its subsidized operations through rediscounts from the Central Bank. Central banks often do lend at preferential rates to the government itself, however. They may also in the end absorb the cost of the operations of the sectoral lending institutions.

Credit ceilings and floors. Another fairly prevalent form of quasi-fiscal activity stemming from the central bank's role as regulator of the financial system is the setting of credit ceilings and floors. It is not uncommon, for example, for the banking system to be required to attain some minimum lending target to the agricultural sector. In India, the commercial banks are expected to lend 40 percent of their portfolio to a number of priority sectors that include agriculture. These policies can thus influence the cost and availability of credit, and so effectively tax or subsidize different forms of credit.

Reserve ratios. These can also be manipulated to favor certain sectors. A related practice is the manipulation of the composition of assets deemed to be liquid for the purposes of the reserve requirement. When the government requires the central bank to enforce an excessively high reserve ratio, it can obtain for itself a captive source of financing. A similar end is achieved by requiring that a disproportionate share of liquid assets be held in government paper. These kinds of policies have been used by governments as a means of financing excessive deficits, while avoiding as far as possible the monetization of the deficit. In extreme cases, the private sector is severely crowded out, and the banking system serves essentially as an intermediary for the government. Something like this happened in Argentina in the mid- to late 1980s.

Apart from the impact such a policy has on the cost of credit to the private sector, it can generate a substantial quasi-fiscal expenditure if the government does not pay the central bank a market-related rate of interest. Specifically, the central bank may have to pay such a rate on its reserves to avoid pushing the banking system into financial difficulty. Not earning a rate on its loans to the government, it can incur heavy losses.

Bank rescues. A fairly common practice is for the central bank to take over the nonperforming loans of banks in distress, often in exchange for interest-bearing treasury securities. A direct infusion of capital may also be a part of the rescue effort, and sometimes the affected institutions have been merged, closed, or privatized. The rescue effort mounted by the Bank of Chile in the early 1980s involved a takeover of nonperforming loans. These operations can create a significant risk of moral hazard, because they can encourage the banks in question to persist in the risky lending practices that got them into trouble in the first place. For this reason, it is generally recommended that the rescue effort include a tightening of prudential regulations and other measures to reduce the risk of a reoccurrence. Another part of the solution may be a deliberate policy decision by the government not to involve itself in the lending decisions of banks and other financial institutions.

What is to be done?

A first step in tackling the ramifications of quasi-fiscal activities is to at least bring them out into the open to the extent possible and transform them into normal budgetary activity. This can be done by transforming quasi-fiscal taxes and subsidies into explicit taxes and subsidies. But this "budgetization" process is likely to encounter political opposition. Moreover, some quasi-fiscal activities are very

difficult to quantify—the subsidy element in a stipulated floor on commercial bank lending to the agricultural sector may simply not be known—so that this inevitably may involve an element of guesswork. In any case, it should be emphasized that a policy of "budgetization" will often be distinctly inferior to outright elimination of the activities.

The good news, however, is that the macroeconomic impact of quasi-fiscal operations can be approximately captured, even when these operations cannot be precisely calibrated, by measuring the net income of the central bank. The central bank's income statement is, not surprisingly, affected when the bank is obliged to assume what are essentially fiscal activities; it will reflect the sum total of the impact of each of the quasi-fiscal activities it has assumed (even if most or all of them cannot be precisely measured) plus its regular operations. Thus, in some countries, the combined deficits of the central government and the central bank may give a better measure of the real financial balance of the central government than the conventional measure—an approach that the IMF often uses in its programs with member countries. The use of this combined measure will be necessary when it is not possible to attribute the cost of the fiscal activities of central banks to the government budget. Nonetheless, an effort should be made to bring the quasi-fiscal operations into the budget. Like mushrooms, quasi-fiscal operations, particularly the more costly ones, are not likely to flourish in the cold light of day.

Even with better numbers and greater transparency, however, the taxes and subsidies created by the quasi-fiscal activity will remain. Since they can be highly distortionary in their effects on the economy, as well as a source of macroeconomic disequilibrium, more radical action will be necessary. Thus, in the case of an MER system, the rates would have to be unified. If the MER were generating a net tax for the government—if it had a positive impact on the net income of the central bank—then this reform would have to be part of a more general tax or budgetary reform that finds an alternative revenue source or realizes expenditure economies.

In the end, a permanent solution to a troubled financial system is clearly not repeated bailouts, but more fundamental action—the closing or merging of some institutions, and the revamping of banking regulations. The balance sheet of the central bank or other public financial institution that has been weakened by years of loss-making quasi-fiscal activity will have to be strengthened by such measures as a transfer from the government of interest-bearing securities.

Finally, the importance of structural reform may be especially great for economies in transition, where it is particularly difficult to draw a line between the functions of the nonfinancial public sector and public financial institutions. Reform has to extend beyond even the financial system so that the systemic pressure on banks to continue providing credit to loss-making enterprises is eliminated at its source. Indeed, quasi-fiscal activities in the setting of a formerly centrally planned economy are in a sense only a symptom of a far greater problem—namely, the lack of incentives in the public enterprise sector for financial discipline. ■

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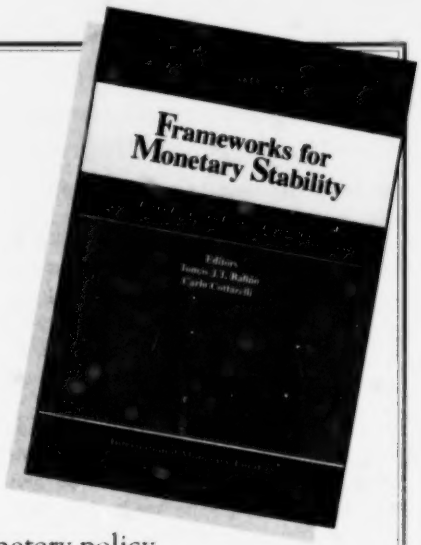

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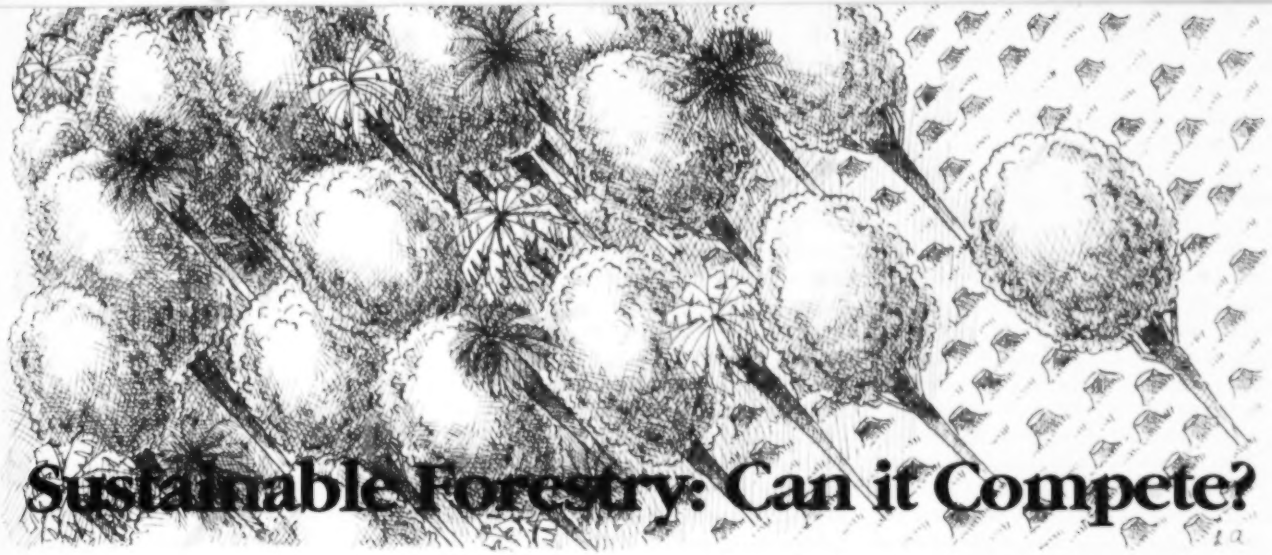

Sustainable Forestry: Can it Compete?

NALIN KISHOR AND LUIS CONSTANTINO

SUSTAINABLE forest management, though a desirable environmental goal, is seldom practiced in Latin America (or elsewhere) because it cannot financially compete with alternative forms of land management. The world community must be willing to bear more of the costs if it wants to make sustainable forestry a viable option for countries facing the threat of deforestation.

Forests, the world over, are threatened by conflicts of interest between those who want to protect the country's natural resources and those who wish to develop the land for commercial purposes. Forests are an essential biological resource, and their services extend far beyond the mere supply of timber. They are a source of vital nonwood forest products (e.g., medicines, nuts, latex, chicle, and rattan). They conserve the soil and protect watersheds. They are natural habitats for global biodiversity. And they play a key role in the sequestration of carbon (i.e., since forests form a repository for carbon, their uncontrolled destruction would lead to carbon dioxide releases into the atmosphere, possibly adding to the global warming problems).

Deforestation worldwide is endangering many of these environmental values. Because these values are local or national, as well as global, in character, deforestation is thus a cause of great concern both within the resource-owning countries and to outside environmental interests.

The emerging debate on how to protect forest resources has focused on which practices can best protect the environment and still allow economic gains from controlled commercial activities like timber harvesting and extraction of other products—that is, "sustainable forest management." This concept allows for some productive and extractive activities, and thus entails a lower cost than cordoning off forests in strictly protected areas. For example, a farmer can stagger his sales of timber so that some part of the forest is always maintained in its natural state. Sustainable forestry is also more politically acceptable to developing countries because it contributes directly to the local economy. Strict protection, on the other hand, is often viewed as only benefiting foreign countries.

In spite of the support of regional governments and international and bilateral organizations, however, this type of land use is the exception rather than the rule in most countries. Policy distortions and institutional failures are partly to blame. In addition, information and technological requirements seem insurmountable. Nevertheless, even if all of these concerns are addressed, a study we recently undertook to identify the factors that influence land use decisions in Costa Rica shows that it is mainly the lack of private demand for this form of land use that has limited its spread.

Land options

Why is there a lack of demand for sustainable forestry practices? Let us recount a story involving four players in the forestry sector—a poor, small farmer; a wealthy and well-connected farmer; a local taxpayer; and a well-off citizen from a developed country. The first three live in a poor country with tropical forests, while the last one lives in a rich country. Both farmers have put claims on separate pieces of land covered with forest, and have been given title to them.

The land they own is a dense tropical forest with an immense variety of plants, animals, and other resources waiting to be discovered. But the only really marketable product is the trees, which are of various species, ages, and sizes. A few trees are valuable because premium furniture can be made from them. Some are suitable as timber for construction, which means they can be sold to small logging companies that will cut and remove them, in the process improving access on the farm. The

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vast majority, however, are of little commercial value—barely worth the removal cost.

Each farmer must decide what to do with his respective land. He or she obviously wants to get the maximum possible income stream, but the soil is poor and not capable of sustained agricultural production. Timber or cattle appear to be the only viable alternatives. The farmers will not consider leaving the forest alone because they could not get any money out of it.

Mining the forest. The farmers' first thought is to cut the forest. They could deal with a few local loggers and sell all the commercially useful trees, regardless of environmental value. After such "mining" of the forest, the majority of trees left behind would have no commercial value. But eventually the forest would grow back in the cleared spaces, not to a pristine state, but to a more degraded condition. In another 40 years, the next generation might be able to sell more trees.

Sustainable forest management. An extension worker from the Forest Service, however, encourages the farmers to practice sustainable forest management. If they sold some—but not all—of the marketable trees now, they would have to wait only 20 years, when an identical number of trees would be ready for sale. This could be repeated in another 20 years and so on. They would make less money now, but more money more often in the future. Moreover, they would be doing a great service to their children and humankind. The forest and the species in it would be left intact, and potentially life-saving medicines could be extracted from forest plants. The biosphere would benefit, as would the local water supply and soil.

Plantation forestry. Next, the farmers meet with a successful local businessman who works for a local pulp and paper company. His business boomed when the government offered generous subsidies for tree planting, which he helped farmers obtain. He says their best bet would be to cut the entire forest: sell all the trees possible, cut down the remainder, and burn them to enrich the soil. Then they should plant laurel (Cordia Alliodora), a valuable native species that grows fast and is easy to sell. These trees would help the environment by absorbing carbon from the air and keeping soil in place—although the net gains would be less than under the mining option, as the latter does not disturb the biomass. The farmers would be able to pay for most expenses with the money obtained from the loggers. Ten years later, sawmillers would crowd at their doorsteps to buy the timber. In fact, they could cut these trees, which regenerate from the stump, every ten years. After 30 years they would only have to plant laurel again and repeat the cycle.

Cattle ranching. Finally, the local cattle dealer argues convincingly that growing trees is not good business, as they take an entire lifetime to grow. "Sell all the good trees, burn the brush, throw in some seeds, and wait for the grass to grow. Buy calves, fatten them, and you can sell them after only two years for meat," he advises. In fact, the farmers could repeat this procedure every two years and become cattle ranchers.

What farmers choose

Both the large and the small farmers consider their alternatives. Although they are concerned about their future and that of their children, along with the environment, they need money now to meet household expenses. Mining the forest would give them immediate income. For the other options they would have to sacrifice income now, but would receive more income in the future.

It is here that the two farmers part. The well-connected farmer decides to go to the local bank and borrow the money to meet his present consumption needs. He already has a large amount of liquid assets and solid creditworthiness. Thus, the bank manager, who is his friend, lets him borrow money at about 12 percent interest. If one of the land use options can make the money he invests grow faster than 12 percent per year, he is better off. After ten years he can pay the bank what he owes, with money left over. He could even borrow from the bank to grow trees or to raise cows.

The need for current consumption versus future needs, and the value that the large farmer places on future income relative to current income, can be "summarized" through a variable called the personal rate of time preference. This rate varies from individual to individual since it depends upon assets, income, education, and creditworthiness. For the large landowner with easy access to commercial finance and good creditworthiness, the personal rate of time preference typically approaches the prevailing market lending rate.

The poor farmer is not so fortunate. He needs money urgently to meet present consumption needs, but his creditworthiness is questionable and a commercial bank will not lend him money (he has few fungible assets, his income is uncertain, and he possesses only a low level of education and professional skills). Hence, the interest rate the commercial bank charges is irrelevant to him. He could get some money from informal credit dealers, but they would only lend at 35 to 40 percent per year, if at all. Because he has to have money to meet his current consumption needs, he would be willing to sacrifice income from his asset today only if he could get an additional 35 percent next year. Thus, he would only consider not mining the forest if he could make sure that natural trees would grow at 35 percent or more, which seems a biological impossibility. More formally, his personal rate of time preference is likely to be in the range of 30 to 40 percent. He would have to be convinced of receiving at least that rate of return tomorrow if he were to choose to deny his family some basic necessities such as food and shelter today.

To illustrate the thinking of the two farmers, it is helpful to consider the net present value (NPV) criterion—which converts all future expenses and revenues into today's income by using the personal rate of time preference. A farmer will choose the option that gives the highest NPV. The higher the NPV, the earlier the net returns accrue and the lower the personal rate of time preference. Because the large farmer's personal rate of time preference is much smaller than that of the small farmer, the NPV of future revenues will be much higher for the former than the latter.

The Costa Rica case

To breathe some economic life into the preceding story, consider real-life data from Costa Rica. We analyzed data from three sites, each characterized by different soil and vegetation types, tree species, and levels of economic development. Since the qualitative results were unchanged, the returns to the four land use options for only one of the sites are reported here. These are given as the NPV in terms of 1989 dollars per hectare in Chart 1. In order to present the results within a "level playing field" all domestic taxes and subsidies have been removed and international prices are being used in the calculations. (Currently, Costa Rica has a $500 per hectare subsidy to managed forestry, about a $1,000 per hectare subsidy to plantation forestry, and a 10 percent ad valorem tax on the sale of timber.

In addition, due to trade policy distortions, the domestic price of timber is only about 40–60 percent of the international price.)

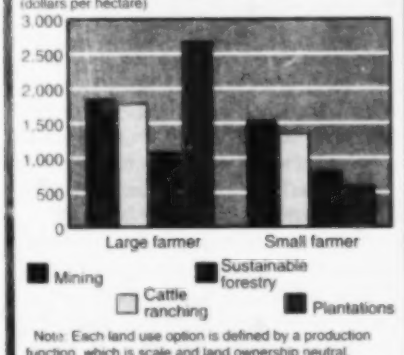
A large landowner (with a long time horizon and an accordingly low personal discount rate) prefers the plantation forestry option over all other options, because the former fetches $2,666 whereas sustainable forestry gives only $1,089. He does not pocket any money immediately. What he gets from selling parts of the forest does not even cover the costs of clearing the land and starting a plantation. But plantation trees grow fast, and he can afford the luxury of waiting because his future income will allow him to pay his loans and have money left over. Sustainable forest management is the worst option, as he must sacrifice some initial income, and the trees in the natural forest grow far too slowly. This is clear from Chart 1, which shows that the NPV of the returns to plantations is almost one and a half times more than that to the mining option, and more than double that of the sustainable forestry option. Empirical evidence also supports this point—corporations in Costa Rica are increasingly undertaking plantation forestry even without using the plantation subsidies offered by the government.

The small farmer, however, prefers to mine the forest. He can sell all the trees possible to the local logger and hope that his children someday might get even more out of the land. He needs money immediately, but no one is willing to lend to him, so the initial inflow of funds would be invaluable. Giving up some of that income to leave more trees in the forest or to buy cattle or plant trees is not a reasonable option for him. Trees or cattle do not grow that fast. In fact, spending all the money he would receive from the logger to plant trees that he could only cut in ten years time is the worst possible scenario. As Chart 1 shows, the NPV of plantation forestry ($594) is about a third of that from mining the forest ($1,519).

Chart 1

Which option is best?

Net present value to the large and small farmers



Note: Each land use option is defined by a production function, which is scale and land ownership neutral. A hundred years horizon is chosen for the net present value calculations.
Source: World Bank.

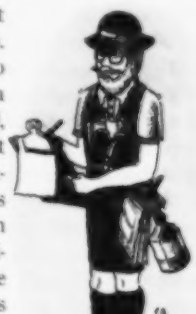
To summarize, the data available shows that, both with high and low interest rates, landowners would move away from maintaining the natural forest.

The other actors

What would the other two actors in the story say about the decisions?

The local taxpayer. A teacher living in the town downstream does not personally gain from what the large and small farmers do, but could stand to lose. The water he drinks, the vegetables he eats, and the electricity that lights his house all come from the river that is fed by the water running through the farmers' lands. If the farmers disturb the soil upstream, water quality will decline, the local irrigation system may have to be replaced sooner, and the local hydroelectric facility may have to be repaired sooner—all of which would require higher taxes. The present value of the additional taxes he would have to pay is calculated as the damage caused by each hectare of farmer's lands that is allocated to mining or plantation forestry instead of being kept under sustainable forestry.

The foreign conservationist. The foreigner is also upset that the farmers have decided not to adopt the sustainable forest management option. He does not care too much about Costa Rican water and soil, but he cares a great deal about the greenhouse effect (and thus about the carbon sequestration capabilities of the forest). He thinks tropical forests should ideally be left alone—the costs to him and to many others like him depend on the adoption of sustainable practices.



Potential for a market exchange. The teacher and other local taxpayers would like to stop the two farmers. But unfortunately for them, the farmers are legally well protected—it would be impossible to enac regulations to prevent them from farmin their forested land the way they pleased Regulations are seldom enforced anyway Thus, the teacher and other local taxpayer might want to calculate what they would b willing to pay to protect the soil and water an offer it to both farmers to practice sustainabl forest management. They would offer more t the large farmer because plantations caus more incremental harm to carbon sequestra tion capacity than mining the forest. But th large farmer would immediately reject thei offer as insufficient compared with what h would lose. The smaller farmer also woul refuse: he would get much more if he immedi ately cut all the valuable trees.

The only solution would be for the foreig conservationist and others like him to poo their resources. Not only would donations b available from people worried about endan gered animals, but an electricity compan eager to mitigate the global warming effects o carbon dioxide from its operation might offe its help. Representatives of both the local an foreign taxpayers could then approach the tw farmers and make them a better offer. Thi time, both farmers would accept.

The Costa Rica numbers game

How much would the small and large farm ers need to be given for practicing sustainabl forest management instead of their privatel preferred options? Table 1, based on Chart shows that the large landowner, who has personal discount rate of 12 percent, requires payment of $1,573 (the excess of the NPV t plantation forestry over sustainable forestry But a poor landowner with a personal di count rate of 35 percent will have to be pai only $717. How much would local and interna tional taxpayers be willing to offer? Becaus the logic behind promoting natural fores management is to ensure the flow of (nonma ket) externality values associated with natura forest cover, one needs to first calculate th value of these externalities.

Environmental values can be classified int three groups: (1) carbon sequestratio (2) hydrological benefits; and (3) existenc value, option values, and ecotourism. Thes are the estimated values of incremental env ronmental benefits of sustainable forest ma agement, relative to the best private optio being practiced by the farmers. Thus, as Tab 2 indicates, for carbon sequestration, the los under plantation forestry relative to sustai able management is about two and a ha times more than under mining. Moreover, th benefits from carbon sequestration do n cover the private opportunity costs of sustai

Table 1
Ensuring sustainable forestry
(dollars per hectare)

	Large farmer	Small farmer
Net present value of payment required to ensure choice of sustainable forest management option	1,573	717

Source: World Bank.

able forest management. For large farmers, an incentive of $1,573 would be needed to practice sustainable forest management, but the benefits from carbon sequestration would only reach $1,356. Similarly, for small farmers who would otherwise mine the forest the incentive required is $717, as against expected benefits of $500.

When all externalities are considered, it makes economic sense for those benefiting from the forests to pay both large and small farmers to do sustainable forestry. If we consider the incremental benefit-cost ratio for the two groups, however, it is 1.49 (=2,344/1,573) for the large farmers, and 2.08 (=1,493/717) for the small farmers. This implies that the small farmer should be the first one targeted to maximize the environmental benefits per dollar of financial transfers.

To whom would the bulk of the externality values accrue? The answer is the outside world (Chart 2). Domestic willingness to pay (as judged by the benefits accruing to nationals) is clearly inadequate to ensure sustainable forestry. This supports the assertion that the world at large must be prepared to make substantial financial transfers to persuade small and large farmers in Costa Rica to adopt sustainable forestry practices.

Looking ahead

Natural forest management is likely to yield more positive externalities relative to other land uses. From the private point of view, however, natural forest management is unlikely to be the most profitable option. Based on some preliminary calculations of environmental externality benefits from sustainable management, relative to alternative land uses, we conclude that there may be room for market transactions. The gains from trade would be larger, the higher the discount rates that farmers face. Thus programs to facilitate such transactions should be directed initially toward small and marginal farmers. These conclusions are supported by data from three sites in Costa Rica, which show that under the current incentive structure, it is almost always more profitable to practice something other than sustainable forestry. (Although widely accepted to be true, more site-specific surveys are required to establish the generality of these results.) Thus, Costa Rica would have to change incentives to make sustainable forest management attractive, and if these costs are too high, the world community would have to consider sharing some of the burden, if it expects to enjoy many of the benefits.

Despite the potential for mutually advantageous gains, at present there are few actual examples of resource transfers aimed at ensuring sustainable forestry practices. One notable initiative is an agreement between NEES (a power company in Massachusetts, US) and Innoprise Corporation in Sabah, Malaysia, to propagate reduced impact logging—an environmentally friendly technique—by bearing the costs associated with it. Two other bilateral initiatives (albeit attempts at replanting rather than preserving pristine natural forests) are: (1) the agreement between AES (a power company based in Virginia, US) and the Guatemalan Government to carry out replantation on denuded hillsides; and (2) the agreement between Forest Absorbing Carbon dioxide Emission (FACE), a foundation set up by the Dutch Electricity Generating Board and the Innoprise Corporation in Sabah, Malaysia, to rehabilitate logged over forests.

What steps need to be taken to encourage further bilateral initiatives—or even multilateral approaches, such as through the Global Environment Facility? The broad answer is that many critical preconditions would need to be satisfied. For example, considering the carbon sequestration benefits from sustainable forestry, a power utility in a developed country would be willing to invest in forest conservation overseas—but only if the investing country had a carbon credit scheme and the recipient country promised the long-term security of those forests. (The FACE contract with Indonesia on rehabilitation of degraded rainforest failed precisely because Indonesia could not give sufficient guarantees for the sustainable management of the replanted forest.) At the same time, the recipient country would want to ensure that such contracts did not compromise its future resource development options or its territorial sovereignty. Thus, the future challenge is to develop the critical institutional mechanisms that will make developed country buyers and tropical country sellers willing to enter into market transactions for the global environmental services provided through the sustainable management and conservation of forests. ■

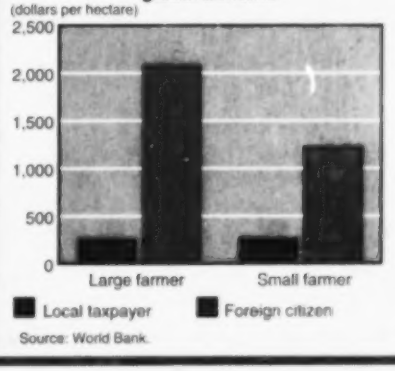
This article is based on the authors' "Forest Management and Competing Land Uses: An Economic Analysis for Costa Rica," LATEN dissemination note #7, World Bank.

Table 2
Target the small farmer
Incremental environmental benefits from sustainable forestry
(dollars per hectare)

	Large farmer	Small farmer
Carbon sequestration	**1,356**	**500**
Hydrological benefits	262	267
Existence and option values, etc. [1]	**726**	**726**
Total	**2,344**	**1,493**

Source: World Bank.
Note: Incremental environmental values have been computed on the basis of "production functions" for each broad category of environmental benefits, specific to each land use option.
[1] Existence and option values have been estimated on the basis of a transfer-of-funds approach applied to several protected areas in Costa Rica. Ecotourism values have been taken from the literature on the travel-cost approach applied to Monteverde rainforest reserve in Costa Rica.

Chart 2
Foreigners gain more than nationals
Net present value of local and global benefits
(dollars per hectare)



Source: World Bank.

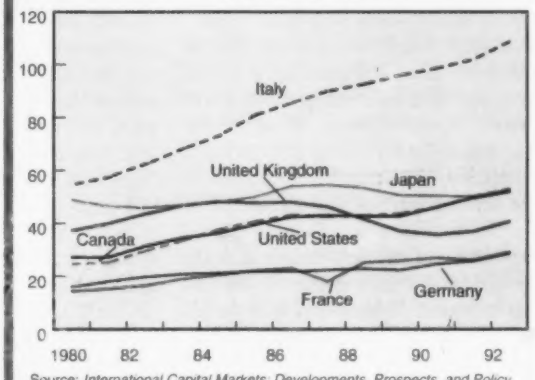
The Changing Nature of

GOVERNMENT securities are the backbone of world securities markets. Their turnover far surpasses that in any other financial market, except the global foreign exchange market. In recent years, government securities markets have undergone great changes.

As many industrial countries ran sustained budget deficits in the 1980s and early 1990s, the size of the government securities markets mushroomed. For most major industrial countries, the ratio of government debt to GDP has expanded greatly since 1980 (see chart). Meanwhile, trading volume in government securities skyrocketed, with the average trading volume in the United States, for example, shooting up from $14 billion a day in 1980 to $120 billion a day in 1993 (Table 1). Increases of similar magnitudes occurred in other countries, although the volume traded in these countries still substantially lags that in the United States.

The increase in the ratio of government debt to GDP has challenged the governments of industrial countries to minimize the cost of financing their debt. With high debt levels, the benefits to a small reduction in the cost of financing are substantial; for example, a government with a 100 percent debt-to-GDP ratio would save a tenth of a percent of GDP each year if it reduced its interest costs by a tenth of a percentage point. As debt levels have grown, along with the pressure to reduce financing costs, one thing has become clear: governments can no longer rely exclusively on domestic investors. This has been particularly true as capital controls were dismantled in many countries, and domestic investors no longer provided a captive market. In order to reduce debt service costs, governments have had to turn to international investors—in particular institutional investors. Indeed, as shown in Table 2, the composition of holders of government debt has changed considerably in recent years. Among the large industrialized countries, international holdings

Government debt rapidly expanded
(percent of GDP)



Source: *International Capital Markets: Developments, Prospects, and Policy Issues*, IMF, September 1994.

Table 1

Trading volume in government securities skyrocketed
(daily average in billions of dollars)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
United States [1]	13.8	18.1	23.5	30.3	38.5	55.5	68.8	77.1	70.7	77.9	76.7	86.1	105.2	119.6
Japan														
Over-the-counter market in Tokyo	1.4	1.6	1.8	2.3	4.8	17.2	29.1	73.9	62.1	49.5	44.1	38.5	44.2	57.6
Transactions in stock exchanges	0.0	0.1	0.1	0.2	0.5	0.8	1.5	1.4	1.2	1.0	0.9	0.5	0.2	0.2
Germany [2]	--	--	--	--	--	--	--	2.3	3.7	3.7	3.9	4.3	6.2	9.7
France [3]														
Short- and medium-term securities	--	--	--	--	--	--	0.2	1.2	2.1	2.5	2.9	3.7	7.6	13.7
Treasury bonds	--	--	--	--	--	--	--	--	--	--	--	--	8.2	14.4
United Kingdom	1.4	1.2	1.4	1.3	1.4	1.3	2.5	7.4	7.9	6.3	6.8	7.8	8.5	9.5

Source: *International Capital Markets: Developments, Prospects, and Policy Issues*, IMF, September 1994.
[1] Primary dealers transactions of US Treasury securities.
[2] Stock exchange turnover for bonds of the Federal Government, Federal Railways, and Federal Post Office.
[3] Secondary market transactions in central government securities, including repurchase agreements.
-- Data not available.

Government Debt Markets

of government debt have expanded in Canada, the United Kingdom, and especially in France and Germany.

To enhance the attractiveness of the debt to international institutional investors, countries have undertaken a wide range of reforms to boost the liquidity and transparency of their market. The 1994 *IMF International Capital Markets* report outlines the reforms implemented by various industrialized countries. While the report focused on debt management in industrialized countries, these reforms may be of interest to developing countries as well. Some of the reforms are highlighted below.

Primary dealer systems. Governments in many countries have appointed a group of dealers as "primary dealers." The United States has long had a primary dealer system, and in the last ten years countries such as France, Italy, and the United Kingdom have adopted similar systems. Indeed, trading volume in France and the United Kingdom (Table 2) increased greatly after the introduction of primary dealer systems and other reforms in 1986 and 1987, respectively. Primary dealers in all countries are required to make active markets in government securities, in good times and bad. This requirement helps ensure a degree of liquidity in secondary markets for the debt. Other obligations—and the privileges primary dealers get in exchange—vary widely from country to country.

Position financing. Another, more controversial, reform is the institution of a market in repurchase agreements (repos). These are contracts for the sale and subsequent repurchase of a security, which allow the holder of a security to borrow cash with the security as collateral. Such contracts, along with similar facilities for securities lending, make it easier for participants in financial markets to take positions in securities and also to establish short positions. Part of the controversy behind repos is that they allow investors to take highly leveraged positions, which if investors are forced to liquidate, may contribute to bond market turbulence. However, the United States has a huge market for repos in government securities, which is widely believed to contribute to the unparalleled liquidity of the US government debt market. Repo markets have grown recently in some other countries, but restrictions remain in Germany and the United Kingdom.

Other reforms. Other reforms that industrialized countries have implemented include:

- concentrating debt maturities in a small set of standardized "benchmark" issues;
- moving to auctions rather than syndicated issues;
- setting a predictable issuing calendar;
- establishing futures contracts on government debt;
- creating a safe and efficient clearing and settlement system with delivery versus payment and a book-entry system; and
- eliminating withholding taxes on government debt.

The sequencing and precise nature of these reforms has inevitably differed across the industrial countries, and few countries have adopted all of these reforms. But all of these measures can help enhance the liquidity of government debt markets and contribute to an expansion of a country's investor base. By increasing the investor base, governments can reduce their debt service costs and free resources for other uses, including reducing the size of debt outstanding.

John Montgomery

Table 2
Tapping the international market
Holders of government debt
(percent of total debt outstanding)

Selected countries	1980	1986	1992
United States			
Domestic banks	18.2	12.3	10.4
Domestic individuals	19.0	10.2	10.2
Other domestic holders	41.8	61.1	60.1
Foreign	21.0	16.4	19.4
Germany			
Domestic banks	69.7	59.5	54.3
Other domestic holders	21.2	20.3	19.4
Foreign	9.1	20.2	26.3
France			
Domestic banks	--	19.6	8.2
Other domestic holders	--	79.6	49.2
Foreign	--	0.8	42.6
Italy			
Domestic banks	41.3	28.1	17.0
Other domestic financial institutions	5.3	12.7	9.2
Private sector and foreign	53.4	59.2	73.7
United Kingdom			
Domestic banks	4.9	6.7	3.8
Other domestic financial institutions	60.0	63.3	61.3
Domestic individuals	16.3	12.0	8.9
Other domestic holders	9.9	8.2	8.5
Foreign	8.9	9.8	17.4
Canada			
Domestic banks	16.4	8.8	11.5
Other domestic financial institutions	23.7	25.6	29.8
Other domestic holders	46.1	48.1	34.3
Foreign	13.9	17.6	24.5

Source: *International Capital Markets: Developments, Prospects, and Policy Issues*, IMF, September 1994.
--: Data not available.

For further analysis see International Capital Markets: Developments, Prospects, and Policy Issues, *IMF, September 1994.*

A New Project Cycle for the World Bank?

ROBERT PICCIOTTO AND RACHEL WEAVING

AT THE WORLD BANK, a new project cycle is evolving that is better adapted to the increasingly risky, volatile, and participatory framework of development assistance today.

For development agencies such as the World Bank, the operating environment of 15 years ago—even of 5 years ago—no longer applies. Planned economies are being replaced by market economies. Centralized decisionmaking and resource allocations are being supplanted by a nearly universal focus on policy adjustment and better governance. At the same time, with the realization that structural and institutional weaknesses are holding back adjustment efforts and delaying economic recovery in very poor countries and transition economies, the focus is shifting back to the basic staples of development economics—capacity building, human resources, and poverty reduction—with a heightened concern for environmental sustainability and private sector development.

As a result, the demands on investment projects have escalated, as have the pressures on development agencies to be more responsive and efficient. This has led the Bank to take measures to improve the management of its portfolio and to lend for projects that are more varied, complex, and wide ranging.

These more ambitious projects promise higher benefits, but carry higher risks. This may help explain why, according to the Bank's Operations Evaluation Department, about a third of the Bank-supported operations completed recently have not reached their major relevant goals, or are not having a satisfactory development impact—compared with 15 percent in the 1970s.

The answer is not to turn the clock back. The new policy priorities hold considerable promise for making development assistance more effective, and they are widely shared within the development community. Instead, experience suggests that the key to better project performance lies in more adept management of risks, streamlined business processes, and more effective capacity building. That means changing the way the Bank has been doing business and reshaping what is known as the project cycle.

Need for change

The traditional project cycle, lucidly articulated by Warren Baum in the December 197 issue of *Finance & Development*, has serve the development community extraordinaril well. Grounded in engineering tradition, thi paradigm—with its orderly progression fro identification to preparation, appraisa approval, implementation, and evaluation— has instilled a professional approach to pub lic investment. It has been particularly we suited to infrastructure development in stabl economies with well-established institution and predictable government policies.

But times have changed, and the traditiona cycle is not easily adapted to the participator risky, and volatile framework of a growin share of today's development busines Indeed, the Bank's evaluation experience su gests that when development projects perfor poorly, it is usually for one or more of the fo lowing reasons:

• Beneficiaries do not participate suf ciently. Participation has often been equat with explaining the project to key stakeholde (individuals and groups who stand to gain

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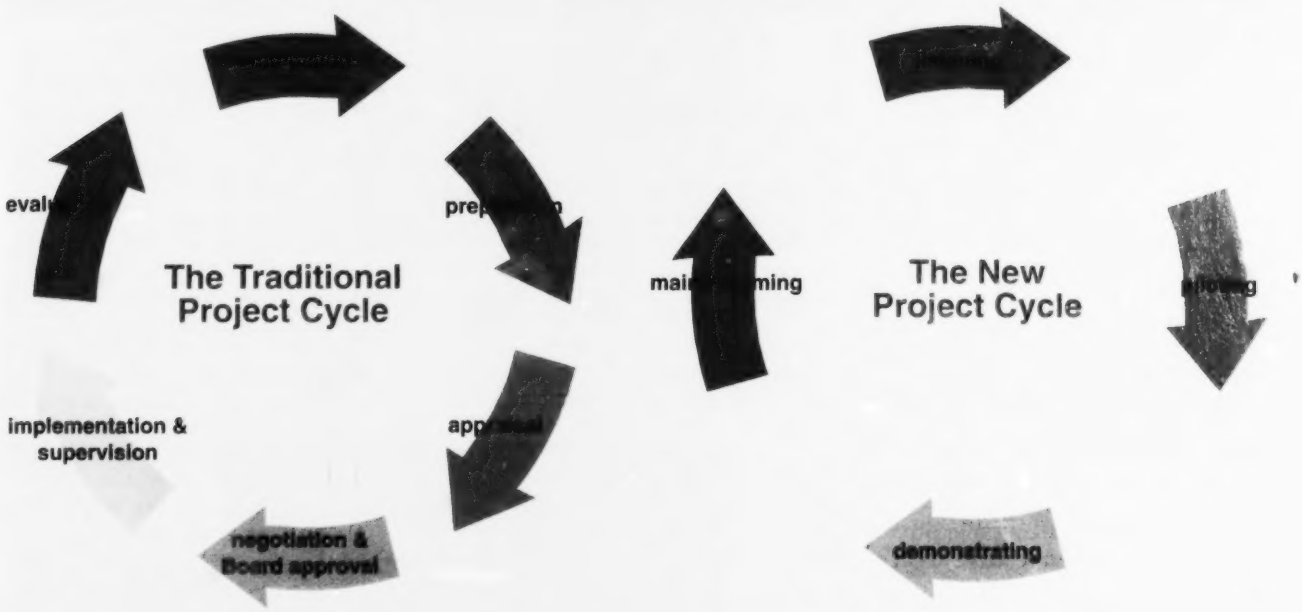

lose from the project), instead of involving them in decisionmaking.

- Borrowers are not committed to project goals. Their "ownership" has been sought by making them responsible for preparation and implementation, instead of ensuring that the impetus for the project is local and that the process provides explicit opportunities for consensus building.
- Risks are inadequately assessed and managed.
- Capacity building has been pursued through separate technical assistance components, for example for staff training, instead of being a core objective that permeates the whole project.
- Project designs are not adjusted to changing conditions in a timely way.

The Bank has launched a major effort to boost the development impact of its operations. An action plan now in progress provides for the introduction of more efficient and client-oriented practices; a greater focus, in dialogues with borrower countries, on how projects are managed; and several measures, such as improved risk assessment and more systematic use of lessons from experience, to improve the quality of operations entering the portfolio. In parallel, business processes are being reshaped to eliminate needless paperwork and to ensure less formalistic and more continuous contact with borrowers and beneficiaries. Equally, to encourage the participation of a wider range of stakeholders, the Bank is implementing the recommendations of a learning group on participatory development. It is also reaching out to nongovernmental organizations (NGOs), both to solicit their views on its operational policies and to involve them in implementing investment projects.

A new project cycle

Within this context, staff throughout the Bank are testing new approaches to processing projects. These approaches emphasize adaptability, government commitment, capacity building, and effective monitoring. Though not codified, they amount to the forging of a new project cycle that:

- centers on the borrower and the beneficiary, not on the requirements of the assistance agency;
- incorporates participation and capacity development features;
- provides for explicit, prudent management of risks; and
- reduces elapsed time and resources spent before initiating action on the ground.

The new cycle—essentially a learning cycle—recognizes that development occurs increasingly in complex and uncertain environments that are not amenable to precise long-term planning or centralized management. At its most fully developed, it comprises a four-stage sequence: listening, piloting, demonstrating, and mainstreaming.

(1) Listening.

In the traditional project cycle, the first step is "identification"—a term that suggests the visual selection of physical goals. The new project cycle starts with "listening." This term symbolizes the learning dimension of projects, the central role of the borrower, and the participation of potential beneficiaries right from the start. The thrust of the listening phase is an open-ended but systematic inquiry into the views and concerns of all significant stakeholders. When all participants listen, they learn from one another and use the information to clarify project goals and to gather relevant experience and insights.

The preparation of a health project that the Bank is assisting in the Lao People's Democratic Republic, for example, shows how listening can help shape the goals. In workshops led by Laotians, Bank staff acted as resource persons, using computer models to show the financial and manpower implications of various options as they were discussed. As a result of this instant feedback, participants shifted the emphasis of project goals from curative to preventive care. Similarly, in Côte d'Ivoire, Bank staff took part in local working groups that brought together government and nongovernment representatives interested in urban development. The strategy that has emerged is less comprehensive than a conventional Bank strategy, but it targets areas in which external support for institutional and regulatory reform is judged likely to be especially effective in removing barriers to improving living standards.

Listening brings the demand side of the equation into the picture, by eliciting the preferences and values of people who are to be affected by projects and policies. It ensures that supply-driven initiatives do not survive unless they elicit a broadly based response from potential beneficiaries as well as a credible commitment from the borrower agencies.

In Espirito Santo, Brazil, a Bank-financed

project to improve environmental and urban health conditions shows the value of wide-ranging talks among state water and environmental agencies, community representatives, and Bank staff. Household surveys taken during the discussion phase found that poor households without water and sanitation, and those with unreliable service, were prepared to pay substantially more for services than they are now paying. As a result, project designers expanded the goals from coastal environmental clean-up to improvements in water supply and sanitation, with a strong focus on poor urban neighborhoods (see "Listening to the Poor" in this issue).

(2) Piloting.

The second phase—"piloting"—is geared to exploring alternatives identified at the learning phase and objectively assessing risks. Pilot projects are deliberately small. They can be funded without elaborate internal review processes, thus reducing the time needed to start project activities. In Mozambique, for example, an International Development Association credit for natural gas engineering is financing a pilot project to prove gas reserves, test the feasibility of an eventual large-scale pipeline to South Africa, and help put together financial and marketing arrangements for a gas development project. The pilot follows an extensive period of "listening" and joint preparatory work by the government, private sector interests, oil and gas companies, potential users, potential financiers and investors, and the Bank.

Pilot projects test local leadership and provide information about the development tasks expected to be replicated at a later stage. They allow different agencies, contrasting project management styles, competing technologies, or alternative sequencing of investments to be tried without incurring major transaction costs or risks. Training of leaders and the design of participatory techniques are integral parts of piloting—along with exploring the social, physical, cultural, ecological, and institutional aspects of the project.

(3) Demonstration.

Based on the results of the pilot, the "demonstration" phase provides the opportunity to fine-tune and adapt project concepts—for example, to confirm hypotheses identified at the pilot phase through trials on a representative scale, and to confirm that risks are manageable and that the project potentially has a satisfactory development impact. This third phase also enables planners to set up management information systems and to work out cost sharing or cost recovery arrangements. The emergence of visible benefits at this stage helps to reinforce ownership and thus the potential for replicating the project on a larger scale.

The demonstration phase ends when consensus is strong, enough skilled participants are available, and enough experience has been accumulated to carry the project into its final phase. In India, for example, in 1990 the Ministry of Environment and Forests officially endorsed the involvement of village communities and NGOs in the regeneration, management, and protection of degraded forests. Twenty years earlier in southwest Bengal, an experimental project of the State Forest Department had organized villagers into forest protection committees on 1,200 hectares of forest. The project was nurtured until coverage had spread to 152,000 hectares and 1,250 villages. The Bank then supported the demonstration phase in which coverage was extended to nearly 35 percent of state forest land in southwest Bengal.

"The new cycle—essentially a learning cycle—recognizes that development occurs increasingly in complex and uncertain environments ...."

(4) Mainstreaming.

The ultimate aim of development assistance is institutional learning and the achievement of a lasting impact on the country's policies, practices, technologies, and skills. Hence, the new cycle comes to fruition with the large-scale adoption—that is, "mainstreaming"—of methods, techniques, and programs pioneered during the pilot and demonstration phases. India's $85 million Bank-supported National Leprosy Elimination Project, for example, mainstreams a concept that was tested and proven through smaller-scale projects that were implemented by NGOs and assisted by bilateral donors: it relies on community mobilization and participation to educate the public about leprosy, reduce the stigma associated with the disease, and identify cases for treatment.

Transforming a demonstration program into a self-sustaining national program is perilous unless sound foundations have been laid. Thus, mainstreaming needs to be carefully calibrated, phased, and where appropriate, backed up by conditionality. The leadership skills and organizational instruments needed may differ from those that succeeded in the earlier phases. To minimize political interference, special measures may be needed t strengthen accountability and transparenc within the agencies concerned.

To have a lasting impact, this final phas needs to nurture the continued commitmer of major stakeholders not just to the specif methods, techniques, and programs bein implemented but also to the *processes* tha will ensure continuous adaptation to chan ing circumstances as implementation pr ceeds. For nationwide implementatio decentralized methods will often be appropr ate, including reliance on markets and volu tary organizations.

Looking ahead

The new project cycle encourages early co laboration and resulting commitment to th goals agreed on. Its explicit focus o experimentation, organizational lear ing, and risk assessment encourage more realistic project design and pha ing. Most important, it makes the ben fits from development operations mo likely to be sustained.

Within the Bank, staff are applyin elements of the new cycle pragmat cally. The range of alternatives is wid In integrated sector operations in son African countries, the new cycle eve repeats itself: at any given time, parts of th operation may be, say, building roads an training contractors while other parts are co lecting feedback from local contractors an community groups, piloting different types training, and mainstreaming proven constru tion approaches.

The new cycle is consistent with the Bank objective of strengthening its partnership wi other development entities. The pilot pha calls for detailed knowledge of local con tions and a permanent presence "on t ground." Often it will be appropriate for t Bank to build on the work of other organiz tions and to build strategic alliances wi other development agencies; for example, w NGOs and bilateral agencies for the pi stage, and with the regional banks for t demonstration stage.

Experience thus far is encouraging. If t use of these approaches can be expanded a intensified, in consultation with stakehold in client countries and the broader devel ment community, there should then be l need for "rehabilitation," "restructurin "cancellations," and other costly and stress symptoms of excessively rigid and n participatory processes.

Listening to the Poor

LAWRENCE SALMEN

SOUND economic policies can set the stage for reducing poverty, but the poor must be able to seize the opportunities. A new analytical tool of the World Bank—participatory poverty assessment—promises to shed light on the subjective side of poverty, so that the development community's inputs can be fashioned in the most effective manner.

Poverty is best understood by the poor. It is the poor who must escape from poverty, and what motivates the poor to improve their own condition depends on their appreciation of the opportunities open to them, the risks involved in taking those opportunities, and the limitations their condition places upon them. Much of what society does to assist them will only be as good as it is perceived to be by those being served. No matter how much is invested in a school or health center, if poor people decide not to frequent these facilities, the investment will be for naught. Thus, for poverty reduction strategies to be effective and sustainable, they must reflect a systematic understanding of the perceptions of the poor.

It is tempting to assume that the political process will give a voice to people, including the poor. Yet, any realistic assessment of politics and poverty in most countries would conclude that the poor are not well represented in the corridors of power, and their voices are all too absent from debates on policy reform directed at improving their own conditions. In the developing world, many democracies are of recent vintage, and articulation of the perspectives of the

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poor is particularly weak. Special measures are thus required to make sure their views are duly recognized.

In recent years, the World Bank has carried out poverty assessments in all borrower countries. These have involved the development of poverty profiles; a review of government policies related to poverty; an analysis of relevant public expenditures, institutions, and safety nets; and the preparation of strategies to reduce poverty. In 1993, the Bank also began to carry out participatory poverty assessments (PPAs) as an optional component of poverty assessments. The idea was to bridge the gap between policymakers and the poor, by systematically bringing the human, social dimension into this analysis.

PPAs address a wide range of critical questions:

- How do the poor perceive the relative importance of the various manifestations of poverty, such as low income, lack of food security, and propensity to ill health?
- What do they see as the root causes of poverty?
- What factors block their opportunities—for example, insufficient access to assets such as land and credit; geophysical factors causing isolation; and gender, ethnic, class, or religious discrimination?
- How are they affected by labor market imperfections and price increases of key commodities?
- What changes in incentives would be most welcome, and what impact would these changes have on productivity?
- How do the poor view public services (e.g., health centers, family planning programs, schools, or agricultural extension), and how will this affect their willingness to help defray costs?
- How do officially provided safety nets affect risk-taking behavior?
- Finally, how do informal safety nets operate at the community and family levels?

The answers to these questions are vital because they bring out the role of the poor as actors, not merely passive recipients of government largesse or nongovernmental organizations (NGOs) attention. Put in terms of neo-classical economics, the development community knows best what it can supply to meet the needs of the poor, but the poor know best what they need (demand) and what resources and services are available.

Already, PPAs have been or are being conducted in 15 countries: Argentina, Benin, Burkina Faso, Cameroon, the Central African Republic, Ecuador, Ghana, Guatemala, Kenya, Madagascar, Mali, Pakistan, Rwanda, Uganda, and Zambia. PPAs slated for 1995 include Brazil, Costa Rica, Gabon, Mexico, Mozambique, and South Africa. For some countries, rapid PPAs (under two months) have been undertaken, whereas for others, more comprehensive PPAs (roughly six to eight months) have been the norm (at an average cost of $120,000, funded out of both Bank and trust fund monies). Preliminary indications from host-country government personnel and Bank staff are positive: the PPAs serve as a useful complement to traditional economic analyses of poverty.

The methodology of PPAs

How are PPAs conducted? The methodology draws largely from two other analytical instruments used in the Bank: beneficiary assessments and participatory rural appraisals.

Beneficiary assessments have been developed over the last ten years as a way of obtaining client feedback. They entail listening to and consulting with the people affected by development projects and programs for the purpose of identifying important issues and constraints. They aim at systematic listening—the foundation of participatory development—by using data gathering techniques that include:

- *Direct observation,* which may merely count objects of relevance or note behavior traits and patterns.
- *Conversational interviews,* which are conducted with a representative sample of persons drawn from key population groups. The interview is done in an open-ended manner, requiring interviewers who communicate well with diverse persons and have good recall ability as they generally take few, if any, notes during the interview.
- *Focus group meetings,* which are much like the conversational interviews, except that they are done with groups (usually of 6–12 people). They give a quick reading on the viewpoint of a community but have less quantitative precision than the one-on-one conversational interview.
- *Participant observation,* which is the most in-depth method. It entails a trained observer living in a community of the poor for anywhere from several weeks to several months to better understand the dimensions of such factors as local power, ethnicity, gender, and religion.
- *Institutional assessment,* which is the least tried of the methods. It involves interviewing people who may benefit from or who lead key institutions in a community (e.g., community associations, NGOs, local government, religious entities, labor unions, and women's associations).

Participatory rural appraisal aims at a rapid understanding of a development milieu with a high degree of involvement of the stakeholders themselves. Besides the techniques used in beneficiary assessments, these appraisals involve community-oriented activities enabling local people to accumulate and assess information about themselves that is central to development planning. The activities range from seasonal calendar building (helps analyze seasonal changes) and trend analysis (how things change over time, for example, whether education is becoming more affordable) to "ranking" (helps stimulate debate within a group about the relative importance of problems, assets, opportunities, or threats) and "mapping" (helps people organize their thoughts spatially, for example, sketching the community in a way that indicates where the poorest live or where problems arise).

The utility of these qualitative techniques is seldom questioned once they have been tried. People know that the validity of what a person says, especially a poor person unsure of how a stranger might use the information, is apt to be enhanced when discussion is held in a climate of trust. Moreover, "qualitative" does not exclude quantification. Once information is gathered in a naturalistic manner, whereby the respondent becomes the subject of the discussion, the insights gained are probed to a degree that they may be recorded precisely and quantified to the degree possible.

No doubt the most pointed query regarding methodology surrounds sampling. When covering entire countries, it is clearly impossible to have enough guided conversations to represent the poor (and those that affect them) in a statistically significant manner. The PPA's objective, however, is not to obtain the statistical accuracy of a census but to portray the perspectives of crucial concentrations of people. Via "cluster sampling" people are selected as representatives of key types and strata of the poor in a particular national and regional context. In Madagascar, for example, sociolo-

"In several African and Latin American countries, the poor voice a surprisingly similar refrain: the government is seen not as a provider of goods and services but as an exploiter, taking for its own gain."

Turning findings into policy: Madagascar's schools

The reasons the poor people of Madagascar do not send their children to school are: (1) they find school too expensive—primarily monthly "tuition" (*écolage*) charges and the costs of school materials; (2) the school curriculum is not adapted to the reality of day-to-day life (anachronistic socialist texts do little to prepare students for the modern market economy); (3) both physical plant and teachers are insufficient—often more than 80 students are in one class; (4) the preparation and overall bearing of the teachers is not satisfactory (frequent absenteeism, lack of readiness for class instruction, shoddy appearance— mainly due to very low remuneration); and (5) the distance of many schools (5 to 10 kilometers) from places of residence. Due to these reasons, one third (562 of 1672) of the children in the households sampled in the Tulear-South region who had been in school during 1991–92 dropped out during 1992–93.

Recommendations of the people for improving the educational system include: (1) provide pedagogical support to the teachers; (2) revalue the function of teaching, through increasing salaries and otherwise raising the social status of the teaching profession; (3) provide schools with pedagogic materials; (4) create professional/ vocational schools adapted to labor market needs; (5) support school lunch programs; (6) adapt the curriculum to the Malgache culture; and (7) support the initiatives of parents-teachers association, particularly as regards quality control over teachers and school construction.

gists selected (1) the poorest region, in the south, with persistent and intractable drought and little hope of growth; (2) the urban poor in the country's capital city of Antananarivo; (3) two export-producing subregions; and (4) a staple (rice) producing area. Interviews were conducted with roughly 650 poor households in each region, for a total of 2,600 households.

Given that interviewing and participant observation allow one to gain a more in-depth, contextual, and holistic understanding of poverty than does the typical household survey questionnaire, one could say that less breadth is made up for by greater depth. If one considers such classics of social anthropology as *Five Families* by Oscar Lewis (which depicts the conditions of urban poverty as experienced by a small but prototypical number of families in Mexico City) and the standard national statistical surveys (which yield a wealth of data yet little or no contextual dimension), the PPA might be seen to straddle the hitherto largely barren middle ground between the two.

Initial findings

Given the newness of the PPA approach, and the fact that only five of the comprehensive PPAs are complete (Guatemala, Kenya, Madagascar, Pakistan, and Zambia), it is premature to assess the overall value of this work. Yet, even at this stage, a number of findings demonstrate the potential value of this approach. Inasmuch as these findings are about the living conditions of the poor as perceived by the poor themselves they are often critical and negative. Yet, the insights gleaned may become the foundation for constructive policies.

Communication. Large segments of the poor are cut off and feel cut off from any institutional support beyond that of the nuclear family. In several African and Latin American countries, the poor voice a surprisingly similar refrain: the government is seen not as a provider of goods and services but as an exploiter, taking for its own gain. In the words of one poor West African, "The only time we see government is when it comes for our money." In Madagascar's capital, only 38 percent of the poor have radios; in the impoverished south, this drops to 6 percent and most of the radios do not work—so knowledge of government services and support is minimal to nonexistent and people are isolated in their own poverty. The one place the rural poor of southern Madagascar get together to learn what is happening beyond the confines of their own household is the market place, but to date the opportunities this provides for education have not been exploited.

Public health. There are widespread complaints about the quality of care provided in public health centers. People cite the rudeness of health personnel, the fact that they are asked to wait for hours, and adverse treatment as reasons why they seldom or no longer wish to avail themselves of modern health facilities.

In Zambia, PPAs found that the most common determinants of rural poverty were those that leave the household labor force weakened. Such determinants—disability, widowhood, and lack of adult children—are often health related. Problem-ranking exercises carried out in rural villages found lack of access to sufficient health care to be the most consistently cited problem. Other problems mentioned include prohibitive distances to clinics and hospitals, increasingly high consultation fees due to cost-recovery measures, poor or absent drug supplies in clinics, and rude and arrogant health personnel.

Education. Poor people, given major time and resource constraints, see school in terms of costs and benefits. If they see the value of schooling as less than that of having children generating income at home—as many in Sub-Saharan Africa do—then they prefer not to send their children to school.

One particularly dramatic account of how perceptions affected school attendance was from southern Madagascar. Parents expressed dismay at a number of negative features of school teachers: missing classes due to moonlighting on other jobs necessitated by low remuneration; lack of preparation for classes due to inability to buy books; and shoddy appearance due to old, torn clothing. They even saw these teachers as "anti-models" with whom they did not want their children to associate. Similar reasons for not sending children to school were found in Cameroon and Kenya and, in a beneficiary assessment, for Mali.

Alcoholism. In Guatemala, the PPA highlighted a serious problem of alcoholism among the poor. Indeed, abuse of alcohol and drugs was seen as the second most frequent cause of economic crisis in the household (21 percent), after death by sickness or accident (35 percent). Roughly 10 percent of the persons interviewed said that alcohol consumed much of the family income or left the husband so affected that he could not work—meaning the woman of the household had to be the sole breadwinner as well as raise the children. Alcoholism was also seen as causing lack of communication at home, separation between husband and wife, and violence toward women and children.

Policy implications

It is hard to argue with the proposition that public policy should be based on a sound understanding of the needs of people for whom that policy is intended. Clearly, political systems are devised to see that policies are attuned to peoples' wants and meet their needs, and in a democratizing world, governments do give increasing weight to the voice of the people.

Without a doubt, the greatest value of PPAs lies in their potential for giving a voice to the poor and attuning government officials to their situation and their needs. Indeed, in response to the Madagascar PPA, the Minister of Economics, Planning and Social Rehabilitation proposed a "popular bank" to facilitate credit for the poor (similar to the

Grameen Bank in Bangladesh), and permanent "listening posts" that would be staffed by nongovernment personnel.

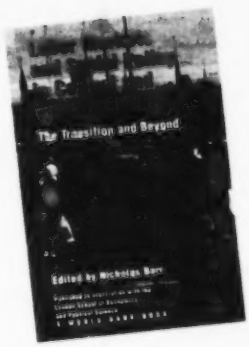
PPAs can also lay the groundwork for more participatory processes through which the poor express their demands and increase their capacity to take advantage of available opportunities and services. Specific findings, such as those cited in this article, can lead to changes in policies and service delivery.

- Regarding *isolation,* the market place can be used as a place of skill and literacy training and other forms of education—a place for the exchange of ideas as well as goods (much as the acropolis of ancient Athens). The importance of feeder roads, rural electricity, and institutions for rural credit for the poor can be reinforced.
- In *public health,* besides the generally known need for more and better-supplied health clinics, it is clear that public health workers should be trained not only technically but in human and personal relations so that they attract and maintain their clientele. Community residents in Zambia also suggested that the training include home remedies and traditional healing methods, which are favored for treating common ailments.
- With *education,* in the cases cited, the paramount need is for adequate remuneration and preparation for teachers to give them a standing in the communities in which they work (see box). Far more effort should also be made to adapt curricula to the day-to-day realities and needs of the poor.
- As for *alcoholism,* bringing the problem to the public's attention is a major step. Increasing public education programs (especially for youth), curative programs for men, and assistance for wives of alcoholics (e.g., day-care and job training programs) could help address this problem.

Governments with large concentrations of poor people often take poverty as a given, in part because of an insufficient appreciation of the perspectives of the poor themselves. PPAs help bring these perspectives into policy formation through systematic directed listening to the poor. After all, the poor must ultimately be the architects of their own development. ■

For further details, see the author's Listen to the People *(Oxford, 1987), and "Reducing Poverty: An Institutional Perspective," Poverty and Social Policy Series, Paper No. 1, World Bank, 1992. Also see* Qualitative Evaluation and Research Methods, *Michael Quinn Patton, Sage Publications, Newbury Park, CA, USA, 1990.*

CHALLENGES FACING NEW DEMOCRATIC GOVERNMENTS



LABOR MARKETS AND SOCIAL POLICY IN CENTRAL AND EASTERN EUROPE: THE TRANSITION AND BEYOND

Nicholas Barr, editor, with a foreword by Václav Havel, President, Czech Republic

Describes the role of labor markets and social policy in raising standards of living and increasing protection of individual freedoms in the former communist nations of Central and Eastern Europe. Suggests that. . .

- **Human resources** must be developed through more effective labor markets, improved education, less poverty, and better health care.
- **The state** still has a strong and active role.
- **Reforms may fail** unless political and administrative realities are considered in policy design and implementation.

The need for better health, transferrable job skills, and well-functioning labor markets are among the goals promoted in this book.

Published for the World Bank by Oxford University Press. September 1994. 416 pages. ISBN 0-19-520998-2. $19.95/Order # 60998.

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BOOKS

Rudiger Dornbusch, Wilhelm Nölling and Richard Layard (editors)
Postwar Economic Reconstruction and Lessons for the East Today
MIT Press, Cambridge, MA, USA, 1993, xii + 246 pp., $40 ($20.00 paperback).
Post-Communist Reform
Olivier Blanchard, Maxim Boycko, Marek Dabrowski, Rudiger Dornbusch, Richard Layard and Andrei Shleifer
Post-Communist Reform: Pain and Progress
MIT Press, Cambridge, MA, USA, 1993, viii + 183 pp., $19.95.
The Economics of Transformation
Alfred Schipke and Alan M. Taylor (editors)
The Economics of Transformation
Springer, Berlin, 1994, xviii and 332 pp., $99

These books contain an interesting array of articles dealing with the task of economic transformation faced by the countries of Central and Eastern Europe and the former USSR. This challenge is placed nicely in perspective by the volume edited by Dornbusch *et al.*, which focuses on post-World War II reconstruction in Western Europe and Japan. In this book, Olivier Blanchard draws the useful distinction between postwar reconstruction ("a process of building upon what existed, a movement out along a ray") and reconversion (which implies "changing, perhaps destroying the existing structure, not building upon it"). The latter, he argues with an eye to the transitional economies of the 1990s, "is much harder to achieve."

One critical difference, of course, is that most of the countries examined (e.g., France, Germany, Italy, Japan, and the United Kingdom)—despite their wartime experiences with command economies or, at least, strongly administered ones—emerged from the war with a legacy of well-developed, market-oriented institutions and a "culture of capitalism". Indeed, as Gilles Saint-Paul notes in his study of postwar France, this "intangible capital," unlike physical capital, was difficult to destroy. And in some cases, even the physical capital stock had increased during the war, as Holger Wolf asserts in his study of (West) Germany. The transitional economies, by contrast, were subject to decades of central planning and systematic attempts to obliterate any signs of entrepreneurship, and entered the transition with a capital stock which, while having grown enormously under planning, was generally ill-suited to the new demands of a market economy.

Another important element in the postwar recovery, which was also followed in many countries by a long period of rapid and sustained growth, was the emphasis placed on expanding domestic competition and promoting openness to foreign trade. J.B. De Long and Barry Eichengreen argue that this emphasis, along with the stress laid on macroeconomic stabilization and curbing the short- and medium-term demands of labor, were perhaps the most important contributions of the Marshall Plan to postwar recovery and growth in Europe. Indeed, they suggest that the conditionality imposed by the Marshall Plan's US administrators in those areas was probably more important to recovery and growth than the financial assistance provided. One can infer a similar lesson from the chapter on postwar Japan by Koichi Hamada and Munehisa Kasuya.

A number of contributors, however, also point to the role of fortuitous factors. Richard Portes, for example, cites the demand stimulus provided by the Korean War, which effectively underpinned the supply-side response anticipated by the Erhard Plan in Germany and the so-called Dodge Line stabilization policy in Japan. Portes suggests that the analogue for the transitional economies in the 1990s will be sound domestic policies matched by "courageous political decisions" by the European Union and other trade partners to expand significantly market access for exports from the East.

The above factors meant, according to Herbert Giersch *et al.*, that (West) Germany "went far beyond a mere reconstruction," a development that "was a miracle in the sense that it came as a surprise to almost everybody." Indeed, they argue that the very fact that the growth in output (13 percent a year on average between 1948 and 1960) exceeded all expectations actually kept wage growth lagging behind the growth in profits and investment, thereby creating a virtuous circle.

The volume by Olivier Blanchard *et al.* is primarily a stock-taking of the stabilization and reform experience in Russia in 1992. Richard Layard poses Russia's dilemma as a trade-off between stabilization and reform, suggesting that greater progress in controlling inflation would have led to unacceptably high levels of unemployment, which in turn would have torpedoed support for the highest priority—privatization. But can one not argue the contrary: that tighter macro policies from the outset would have induced efficiency-oriented changes in enterprise behavior more than it would have undermined support for privatization? Also, to suggest as Layard does, that Gaidar and his team did not attempt an early stabilization is to miss the mark. The Gaidar team did make an attempt—indeed, as Layard acknowledges, the budget deficit was drastically reduced in early 1992—but by mid-1992, both the government and the central bank could no longer resist the demands of the state enterprise sector for subsidies and easy credit.

The authors of this book generally place too much stress on the contractionary impact on output of both tight financial policies (Layard, as well as Blanchard and Marek Dabrowski in their discussion of the Polish experience) and the collapse in interstate trade among the states of the former USSR (Rudiger Dornbusch, in arguing for the need for a type of European Payments Union system). Probably more fundamental has been the combination of (1) the chaotic conditions

unleashed by the dismantling of central planning and the breakdown of financial discipline that had already begun in the latter years of the former USSR; (2) enormous shifts in demand caused by the change from planning to the market allocation of resources and the freeing of relative prices; and (3) the underdevelopment of market institutions to facilitate the rapid reallocation of resources in such circumstances. It is therefore not surprising that there is no systematic evidence of a negative correlation between cumulative inflation and cumulative output declines in the transitional economies. Indeed, the experience of such countries as Poland, the Czech Republic, and the Baltic states suggests that the more rapidly inflation is brought under control, the more stable will be the environment for structural reform and the more rapidly output will begin to recover.

The volume edited by Alfred Schipke and Alan Taylor deals with a range of issues involved in the transition. Schipke's own discussion of privatization insightfully notes its key political dimension. He contrasts the Polish and Russian approaches, and gives the latter high marks for providing a strong impetus to privatization from the beginning by giving the population—mainly through the voucher program—an immediate stake in the process.

Financial sector reform—which in the early stages of the transition almost inevitably means reform of the banking system—is certainly no less crucial than enterprise restructuring, and indeed the two must go together. Reform of the banking sector is key to the further mobilization of domestic saving, ensuring efficient financial intermediation, and encouraging improved corporate governance and financial discipline for enterprises. It is also a condition for the sustainability of macroeconomic stabilization, since the stock of nonperforming loans inherited from the period of central planning and any further accumulation of bad loans runs the risk of a systemic collapse of the banking system or, if that can be averted, a sizable bailout of the banks by the budget.

Timothy Lane offers a number of useful insights into these issues. In contrast to the emphasis laid by Blanchard and Dabrowski on the need for government recapitalization of banks, Lane suggests several arguments against recapitalization, including the role that debt servicing can play in disciplining enterprises and the need to avoid moral hazard as well as the fiscal burden involved. If large-scale government involvement is to be avoided, however, Lane notes that banks have to be given the right incentives (e.g., through privatization) to collect old debts and make judicious new loans. Moreover, this approach is likely to work only in a policy environment in which authorities have clearly fostered a hard budget constraint mentality (in both banks and enterprises) and have taken major steps to improve bank supervision.

These volumes clearly demonstrate that many of the important conditions for successful reconversion as well as reconstruction are essentially the same—financial stabilization, liberalization, and a favorable external environment. What makes the reconversion process in Eastern Europe and the states of the former USSR so particularly daunting is the need to replace a long-entrenched system and ingrained ways of thinking with new institutions and attitudes conducive to an efficient, market-driven economy. For the industrial countries and multilateral institutions, the continuing challenge in the 1990s will be to match the ingenuity demonstrated some 45 years ago under similar—but arguably simpler—conditions in the provision of policy advice, technical assistance, financial support, and improved market access to those countries now undergoing the transition to market economies.

Thomas A. Wolf

Paul Krugman

Peddling Prosperity

Economic Sense and Nonsense in the Age of Diminished Expectations

W.W. Norton and Company Inc. New York, NY, USA, 1994, xi + 303 pp., $22.

Reading Krugman's book is a pleasure. Woven through his basic story line about the intellectual history of professors and political history of policy entrepreneurs are pithy explanations of economic concepts and discussions of recent economic events told in ways that the general public can understand and fellow economists can recognize as clever.

The book is divided in two parts. In the first, Krugman presents the story of how economics shifted to the right in the 1970s. The intellectual triumph of the right consisted of the attack on the foundations of Keynesian economics, the emphasis on the costs of taxation, and the examination of the dismal performance of regulation. Old-style micro- and macro-interventionists were discredited.

However, as the story moves beyond academia into the world of politics, Krugman notes that the conservative, but reasonable, economists (demarcated roughly by Martin Feldstein or Robert Barro) saw their valid scholarly work, which dominated the intellectual field in the 1970s, co-opted and distorted by supply-sider "cranks." These cranks give economic advice, but are not economists. They are "policy entrepreneurs" who sell "ideas that can turn into issues that can turn into votes."

Krugman offers a penetrating account of the supply-siders' hold on national economic policy in the Reagan and Bush years. According to Krugman, these supply-siders—led by Robert Bartley and the Wall Street Journal editorial page crowd—were unconstrained by professionalism (or knowledge) and preached ideas, "cartoon-like in their simplicity." And, in the end, the supply-siders' reign was a disappointment. Their excesses led to massive deficits, no demonstrable increase in growth, and excessive deregulation (e.g., the S&L losses). Krugman also points to,

without implication of causality, a large increase in income inequality.

In the second half of the book, Krugman tells the story of how liberal, but reasonable, economists (demarcated by Professor Krugman) swung the intellectual pendulum back and restored the intellectual case for government policy in the 1980s. Krugman (and others) showed the possibility of activist policies improving on free trade. The work of the neo-Keynesians showed that Keynesian policy was theoretically possible.

When the time came to make policy for the 1990s, however, it was not professors, but yet another set of policy entrepreneurs, who took over the job. This time they were not supply-siders, but "strategic traders" who saw America's economic policy as corporate strategy writ large. The strategic traders propose active government intervention, including trade interventions, to enhance America's competitiveness. Krugman reserves some of his best (and wonderfully sarcastic) prose for these "strategic traders":

If you hear someone say something along the lines of "America needs higher productivity so that it can compete in today's global economy," never mind who he is, or how plausible he sounds. He might as well be wearing a flashing neon sign that reads: "I DON'T KNOW WHAT I'M TALKING ABOUT."

One by one Krugman demolishes the claims of the strategic traders. His explanations of the fallacies of emphasizing international competitiveness over domestic productivity are absolute "must" reading (his appendix on productivity and competitiveness alone is worth the price of the book).

Krugman's book also demonstrates his mastery of one skill envied by any policy entrepreneur—marshalling the eye-catching, mind-changing, sound-bite grabbing, exclamation-point-deserving, statistic. Think the United States is awash in a flood of imports from low wage countries? Think again—the weighted average wage in the countries America imports from is 90 percent of the American wage! Think the expansion in the 1980s under Reagan was good for all Americans? Think again—the top 1 percent grabbed 70 percent of the increase! Think that import competition in the increasingly global economy is responsible for the widening income distribution? Think again—imports as a fraction of GDP were barely higher in 1992 than 1980!

"Krugman's book also demonstrates his mastery of one skill envied by any policy entrepreneur—marshalling the eye-catching, mind-changing, sound-bite grabbing, exclamation point deserving, statistic."

Economists, especially one brand of economists—the "professors," will love this book because it turns them into heroes. The "professors" are however, a rather unprepossessing group of heroes. Krugman suggests that economics is a "primitive science," rather like medicine at the beginning of this century. Economists, for instance, "don't know how to make a poor country rich or bring back the magic of economic growth," but they do know how to avoid "folk remedies for economic distress like import quotas or price controls." But this modest knowledge, mostly of what is false, has put the "professors" ahead—in Krugman's accounting—of the general public, who do not know what is true or false, and ahead of politicians, who do not care what is true or false. In Krugman's view, professors are especially far ahead of their closest competitors in terms of policy influence—the "policy entrepreneurs," whose writings and talking head sayings are "not clouded by too much knowledge of economic facts," because what they claim is true—is usually false.

But this book is enjoyable and useful for more than just economists. The book's basic warning about the difficulties of mixing scholarly detachment that is intellectually necessary for the "professors" with the rough and tumble, attention-grabbing policy entrepeneurship necessary for politics is useful for professor, policy entrepeneur, policymaker, and informed citizen alike.

Lant Pritchett

Barry P. Bosworth, Rudiger Dornbusch, and Raúl Labán (editors)

The Chilean Economy: Policy Lessons and Challenges

The Brookings Institution, Washington, DC, USA, 1994, vii + 441 pp., $44.95 ($19.95 paperback).

This book offers an account of Chile's systematic, comprehensive, and ultimately successful experience of stabilization and market reforms. Chile's initial conditions—a mix of what can be found today in Africa and Eastern Europe—were not unique. Rather, the Chilean experience of 1974–94 stands out because of the resolve and persistence of the reformers and the fact that they undertook most changes either before such changes were intellectually fashionable (such as financial liberalization, trade reform, and large-scale privatization in the 1970s) or when they were simply unheard of and therefore expected to fail (such as pension system reform and targeting of social programs to the poor in the 1980s). Remarkably, most reforms took place under a military

regime, but were eventually embraced by a large majority of the population and subsequently legitimized by democratic rule.

The book sets a high standard of excellence for future reviews of country experiences by focusing concisely on topics of macroeconomic management, major structural reform areas, and Chile's distributive and political-economy features. These themes are entrusted to a group of international scholars who have a thorough knowledge of theory and policy as well as of the country. New and old issues of Chile's experience are distilled, offering fresh viewpoints, new analytical insights, and recent empirical evidence, all dressed in highly readable and mostly nontechnical language.

Like all books, this one has its weaknesses. Its focus is excessively biased toward macroeconomic issues, with too little attention paid to topics of increasing importance, including poverty, education, health care delivery, and the environment. Occasionally, the econometrics seem simplistic. And finally, the reader is left without a clear picture of the development challenges Chile will face in the future. On balance, however, it is a splendid volume offering valuable lessons for other reforming and transition economies. What are these lessons?

In deeply reforming its "clientilist" state, Chile has made its government structure and economic organization less susceptible to pressure groups and lobbies, thereby allowing it to focus on its essential tasks. These include poverty reduction through social programs targeted to the poor and effective regulation and supervision of privatized enterprises in banking, capital markets, utilities, and infrastructure. Simplified tax codes, reliance on market-based prices, privatization of state enterprises and government programs, decentralization of state education and health programs, and an independent central bank all contribute to economic efficiency and strengthened state administration.

Chile's experience also illustrates that optimal sequencing of structural reforms is of less concern than careful planning and committed follow-through of reforms. Here the lesson is that reformers should do whatever can be done as well and as quickly as possible. It is crucial to put competent professionals into all key government positions and to invest them with the authority to withstand the influence of both opposition lobbies and adverse shocks. However, one important reform sequence should be respected: up-front macroeconomic stabilization is a prerequisite for the success of subsequent structural reforms.

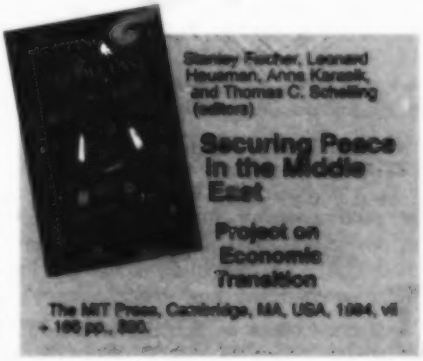
The transition costs of stabilization and structural reform are typically large and the process takes longer than anticipated, particularly when change coincides with adverse external shocks. In Chile, growth based on productivity gains and strong private investment came only after full employment was restored and reform credibility was high—and that took many years.

After reading this book, one might be left with a lingering doubt about the feasibility of transferring these lessons to countries implementing reforms under democratic conditions. But with the hindsight provided by the demise of socialism and the radical reforms that such democratic countries as Argentina, Bolivia, and Poland are undertaking, one tends to infer that most of the lessons from Chile are applicable to democratic reformers. If anything, the shorter tenure of most democratic governments forces them to implement reforms very quickly. In fact, many of the reforms adopted in the three countries mentioned above are being implemented at a much faster pace than in Chile, where, contrary to widespread belief, fiscal stabilization was achieved after only two rounds of 4 years each; trade liberalization was completed in 6 years; and privatization, started 20 years ago, is still ongoing.

However, there are some exceptions to the transferability of Chile's lessons. The book demonstrates that the middle class was the big loser during the initial 10–15 years of reform, when per capita growth was zero while social programs were reoriented toward the poor. A middle class with voting power would not tolerate such a redistribution of income. Hence, democratic reformers must work even harder than the Chilean reformers did under Pinochet, by offering partial compensation to losers, empowering potential winners, or ensuring that the benefits of reform are reaped sooner.

These and many other lessons make this book a must for applied international economists, development specialists, policymakers, reformers, and all those who want an excellent read about a country experience that illustrates at its best the complex interface between finance and development.

Klaus Schmidt-Hebbel


Stanley Fischer, Leonard Hausman, Anne Krueger, and Thomas C. Schelling (editors)
Securing Peace in the Middle East
Project on Economic Transition
The MIT Press, Cambridge, MA, USA, 1994, vii + 166 pp., $20.

Shortly after the Madrid Conference on Peace in the Middle East in early November 1991, a group of Israeli, Jordanian, and Palestinian economists met in Cairo to discuss economic issues related to the transition from war to peace. They were later joined by US economists from Harvard and MIT, and their work, carried out over nearly 18 months under the auspices of the Institute for Social and Economic Policy in the Middle East at the John F. Kennedy School of Government, culminated in a plan for economic transition, skillfully and cogently summarized in this book.

The conclusions and recommendations of the study reflect the views of the economists themselves and not necessarily the policies of their respective countries. Nevertheless, the central message of their report did not substantively diverge from the mainstream consensus that was gradually emerging from the official peace negotiations then under way.

Mainly concerned with the transition period (later defined as a maximum of five years in the Israeli-Palestinian peace accord), the study addresses six issues of critical importance to the transition period: interim institutional arrangements in the West Bank and Gaza, fiscal issues, international trade, the financial sector, labor, and the management of foreign aid. These issues are dealt with at two levels:

the local level, as reflected in the structure of Palestinian selfgovernance in the West Bank and Gaza, and the regional level, in terms of future economic relations among the three key players—Israel, Jordan, and the West Bank and Gaza.

In addressing these issues, the report focuses on the current situation, highlighting key policy choices relevant to the interim period and avoiding delving too deeply into the contested terrain of historical development. The authors see the need to free the three economies of accumulated restrictions and thereby promote open markets and free trade relations among them. They recognize, however, that political difficulties may impede an early implementation of this objective, noting in particular protectionist vested interests in the case of agriculture and security risks in the case of labor movements. Hence, the authors make the case for a gradual evolution toward the desired goals.

But despite the report's strong and convincing case for breaking down economic barriers and for market-driven development in the region, not much is said about the crucial role that the private sector could play in the emerging economic arrangement. This is particularly important for the economy of the West Bank and Gaza where the expatriate Palestinians, who have been so instrumental in transforming the economies of neighboring Arab countries, could conceivably play a pivotal role.

On the question of interim institutional arrangements for the West Bank and Gaza, the authors propose economic and financial structures that, in retrospect, have turned out to be remarkably close to the actual outcome of Israeli-Palestinian negotiations. In addition, almost all the key issues of fiscal and development policy that were later to engage Israelis and Palestinians in intense negotiation are clearly identified and cogently analyzed. Similarly, in the case of monetary arrangements, the report proposed the establishment of a Palestinian Interim Monetary and Financial Authority which, in the May 4, 1994 Paris protocol signed by the PLO and Israel, emerged as the Palestinian Monetary Authority.

Moving beyond the issue of Palestinian autonomy in the West Bank and Gaza, the study discusses wider regional cooperation and proposes the establishment of a Middle East Bank for Cooperation and Development to help facilitate and, perhaps, undergird the new economic relations among states in the region. Although at the time such a vision may have been viewed as utopian, the acceleration of the peace process in recent weeks (especially with the signing of the Israeli-Jordanian accord) could serve to bring the vision closer to reality. A more skeptical reading of the complex realities of the Middle East, including the area's record of unsuccessful regional schemes, may engender some caution, but only about the speed, and not the inevitability, of future regional cooperation.

Central to any notion of regional cooperation is the question of what kind of polity the West Bank and Gaza would need to be in order to fulfill its role in the trinity. Appreciating the complexity and delicacy of such an issue, the report ingeniously proposes that the West Bank and Gaza should have "economic sovereignty within the framework to be reached in the final agreements." The concept of economic sovereignty provides a clever way out of the dilemma, but does it really resolve it? How may the Palestinian authority exercise such economic sovereignty, say in the case of seeking to attract foreign investment, if lack of territorial sovereignty constricts its ability to regulate land use, access to water resources, or control its frontiers?

The tone of the analysis in this well-wntten book is understandably optimistic, and in this connection shows insufficient appreciation of the complex political realities of the Middle East. Such political realities have not only imposed a slow and grinding tempo on the peace process itself, but they have also caused the agreed outcomes to fall far short of the ideals advocated by the authors.

Nonetheless, the book is a timely and important document. It offers a clear and consistent vision of the bright future that awaits a region that has seen more than its share of conflict and strife. Clearly, in a climate of peace, the economics of regional cooperation are compelling, and this report makes the case eloquently and cogently.

George T. Abed

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BOOKS *in brief*

Richard O'Brien (editor)

Finance and the International Economy

The AMEX Bank Review Prize Essays

Oxford University Press, New York, NY, USA, 1994, vi + 187 pp., $14.50

This year's crop of essays is not perhaps the most scintillating in the eight-year history of the essay prize competition; nevertheless, the collection includes a number of interesting and topical essays. The top prizewinning authors, David Folkerts-Landau and Alfred Steinherr, address the thorny question of coping with derivatives. Evidently, derivatives have certain advantages (why else would they be used?) but also considerable risk, as we have recently been reminded. What is to be done? The authors conclude that the "wild beast" should be tamed (through structural market changes), not chained or fenced in. The two silver prize essays are also highly topical. Andrew Freeman deals with the brave new world of financial capitalism, the increasing potential of divorcing ownership from management, and the possibilities this presents for customization of risks and rewards. In the other essay, drawing on much empirical evidence, Michael Klein and Neil Roger discuss the benefits of infrastructure privatization and how to ensure that once privatized it remains competitive. The five bronze prize winners cover the weakness of the dollar and emerging markets (Avinash Persaud), pension funds in OECD countries and emerging markets (Helmut Reisen), the risks of trying to achieve too many objectives through trade policy (David Robertson), corporate financing in developing countries (Ajit Singh), and the effect of internationalization on income distribution in the United States (Matthew Slaughter).

In Memory of Jan Tinbergen

(1903 to 1994)

EVELINE HERFKENS

World Bank Executive Director Representing Inter Alia The Netherlands

AN EQUITABLE distribution of the benefits of development, at the national and international level, has the highest priority and can be achieved. Indeed, it is a matter of social responsibility and political will.

This is what Jan Tinbergen used to teach to innumerable audiences, ranging from rural women to heads of state. For those who met him, the combination of his great intellectual mind and personality often produced a turning point in their lives: he functioned as a conscience, setting an example that proved again and again to be impossible to follow.

Tinbergen disliked dogmatism and intolerance. In that spirit, he advised governments of diverse political persuasions, accomplishing this feat without creating any misconceptions about his own strong sense of social and political values: he was a heartfelt social democrat.

The generations of Dutch he convinced form the constituency for the generous Dutch development aid. But his influence went much further. During the 1950s and 1960s, his views on development planning had a great impact on policymakers worldwide. Through his work and personality he made an unforgettable impression on many students, who later achieved high positions in society and science. And he exerted influence in the then so-called second world, although he did not support the communist approach to central planning. (He attached importance to democratic procedures to achieve optimal planning. His convergence theory conflicted with the Marxist-Leninist philosophy, which perceived communism to be the ultimate societal order, and supported those who campaigned for decentralized decisionmaking.)

His ideas

Tinbergen felt that economics should be at the service of humanity, which is why he devoted his life to understanding, ordering, and maximizing the effectiveness of the tools through which economic progress could be accelerated. He taught that multiple economic objectives cannot be achieved with a single instrument: different objectives need different instruments—a lesson that is still neglected. After all, macroeconomic stability does not guarantee growth, and growth does not necessarily lead to more employment and less poverty.

Although he received the Nobel Prize for his contribution to econometric modeling, he was the first (in his lecture at that occasion in 1969) to question the importance of theory: models constitute a framework or a skeleton and the flesh and blood will have to be added with a lot of common sense and knowledge of details. Mathematics and "planning" are instruments to enhance the quality of policy decisions to improve living standards. He emphasized the importance of political and social factors and valued interdisciplinary cooperation.

Today, as the role of the public sector is challenged, some feel that Tinbergen's confidence in the effectiveness of government was naive. However, his idea of "planning" related to coherence between policy instruments and policy objectives. Regarding the comprehensiveness of the set of instruments, he was pragmatic: they may differ from country to country in the light of the specific situation. As early as 1950, he acknowledged that planning may hamper efficiency and may weaken incentives to adjust and innovate. Indeed this led to the demise of the Soviet Union 40 years later. However, he also argued that the limitations of the market mechanism demand pro-active government: he was very concerned about the present overconfidence in market forces given the resulting social inequity and environmental degradation.

In his early work, Tinbergen concentrated on national economic policy issues. Nevertheless, he was one of the first to acknowledge the lack of equity in the economic and financial relations between industrialized and developing countries in the post-colonial era. His writings on this subject have contributed to several international initiatives to support development in the past decades, although he was disappointed every time as these initiatives always contained less than he felt necessary. Much of his work in this field (e.g., "Reviewing the International Order," 1976) contains food for thought for the prestigious committees that have recently been established in connection with the 50th anniversary of the Bretton Woods institutions.

Jan Tinbergen was ahead of his time in many other ways. He emphasized the need to invest in people through education and the need for accountable institutions, rule of law, and social stability—in short, the need for what recently has been termed "good governance," a topic that now dominates the development debate.

An example to all

Tinbergen's lifestyle was fully in harmony with his beliefs. Indeed, there are many anecdotes that attest to his affable modesty and frugality. One of my memories that best characterizes him was something that happened after we both participated in a panel discussion in Amsterdam. As a staunch supporter of public transport, like him, I did not (and still do not) own a car. But although I advertise this, I am always happy to accept a ride. When I realized that he also had to return to The Hague, I suggested to him that he join our group. He was tired—then already in his seventies—and looked relieved. However, his face clouded up when he realized that he (the most important participant in the forum) had forgotten to pay for his cup of tea, and he asked us not to wait while he took care of this obligation.

Until the end of his long and productive life, he continued to focus on critical issues, ranging from child labor to the volume of development assistance, although his objective of a more equitable world seemed to slip further and further away. Re-reading his work, it is astounding how much of what he wrote is still relevant today. Without question, the world would be a better place if we had listened to him more carefully and acted

LETTERS

Palestinian autonomy

We attach great importance to the economic welfare of the Palestinian autonomy; future development of both Israel's economy and that of the autonomy depends on mutual cooperation. Furthermore, we believe that a successful fulfillment of the agreements signed between Israel and the PLO depends to a great extent on improving the living conditions of its citizens, and we declared on many occasions our willingness to support this process. However, it should be noted that the term "Palestinian State," which opened the Editor's letter of the September 1994 issue, does not appear either in the "Declaration of Principles" (which was signed in Washington in September 1993), or in the subsequent Cairo Agreement. It is precisely because the future political shape of the autonomy at the end of the process has not been defined in these agreements that made their signing possible. By the same token, a fully successful implementation of these agreements depends on the avoidance of a political prejudgment.

Gideon Schurr
Bank of Israel

Measuring the impact of adjustment

Ishrat Husain's article ("Results of Adjustment in Africa: Selected Cases," *Finance & Development*, June 1994) notes that Nigeria has had a large turnaround in per capita GDP growth during the adjustment period 1986–91. However, measuring the impact of policy reforms in terms of an increase in GDP does not reveal the true picture.

Policy planners must have a human face and look beyond the numbers. The key test of any policy change—structural adjustment in Nigeria's case—is whether the poor have been made better off. In Nigeria, poverty has remained the same, if not increased, as a result of high inflation, unemployment, and low investment. To say that food prices have declined in Nigeria may be statistically true. But the story would be quite different if one had to ask a Nigerian who has to pay ten Naira for a tin of evaporated milk that used to cost one Naira. The same holds true for other food items, rent, transport, etc.

Further, adjustment measures, in particular the deregulation of interest rates, have hurt industry. When the level of interest rates (and fees that the banks charge) works out to around 36–40 percent per annum, how many investment proposals will pass the profitability test? Thus, measuring the impact of reform in terms of an increase in per capita GDP masks critical issues. How the increase in GDP is shared may perhaps reveal a truer picture.

S. Viswanathan
Bombay, India

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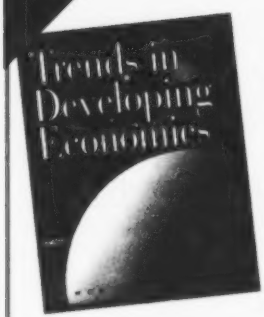

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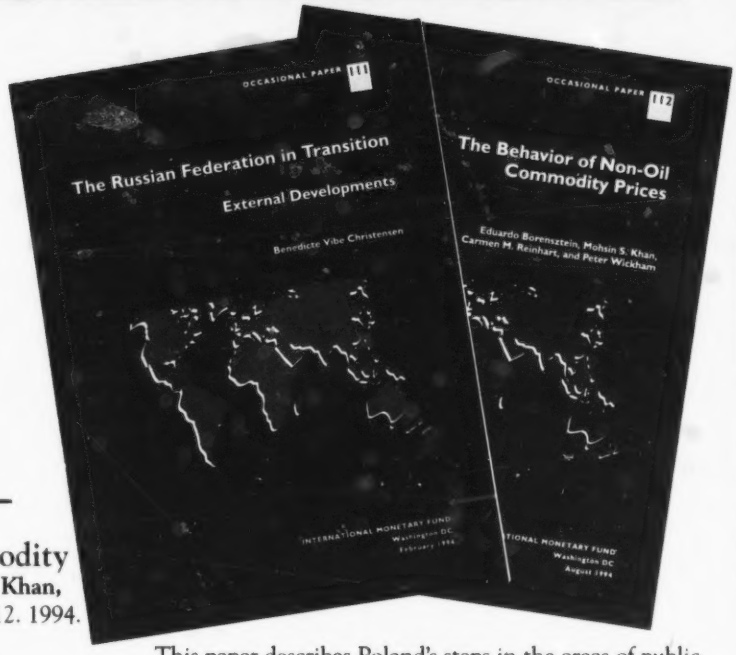

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